INSEAD Global Executive MBA Project

INVESTING IN FRENCH DISTRESSED DEBT

Field: Finance

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DISCLAIMER: This paper does not contain investment advice or legal advice.

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INTRODUCTION

Distressed debt. A “distressed debt” is a debt (e.g., a bond, a bank loan, a trade debt) owed by a debtor “in distress” in that it is undergoing financial difficulties (but not necessarily insolvency proceedings) greatly increasing the likelihood of the debt’s interest payments and capital repayments not being made when due. Professor Edward I. Altman, who is considered by many as the most authoritative author in this area in the United States, include in distressed debts for statistical purposes bonds selling at a yield to maturity at least 10% over the yield to maturity of 10-year treasury bond, bank loans selling at below 90 cents on the dollars and of course defaulted debts[1].

Distressed debt investing. Distressed debt investing consists in purchasing, generally[2] at a significant discount, distressed debts with the objective of either cashing or reselling same at a profit within one year without taking an active role in the borrower’s reorganization, promoting a plan of reorganization that increases the value of the debt purchased by the investor as it is swapped for new debt or equity (and exiting within the year following the reorganization, thus holding the investment for one to two years), threatening to veto and ultimately selling the investor’s consent to a plan of reorganization (and exiting in the same timeframe), or buying key assets of the company or swapping the debt for enough equity to control the company (and holding the investment for two to three years).

Distressed debt investors and market. Investors in distressed debt include a potentially large spectrum of players from hedge funds that trade in distressed debts to private equity funds that focus on control buyouts. The biggest distressed-debt investor is, both terms of number of funds and amount of capital raised, is Oaktree Capital Management, which is currently raising a new fund, Oaktree Opportunities Fund IX LP, seeking commitments of at least USD 4bn. and targeting U.S. and European opportunities, while Global Management LLC has been marketing a fund to purchase nonperforming loans in Europe and Avenue Capital Group has been raising a European distressed strategy fund[3]. Capital Management, Strategic Value Partners, Trafalgar Asset Managers, and Soros Fund Management are other active players, as well as Goldman Sachs and Morgan Stanley for instance.

According to Prequin research[4], 122 distressed debt funds have closed between 2004 and August 2011, raising a total of USD 146.6bn., representing 74% of USD 197.3bn., the total distressed private equity capital raised from 2004 to August 2011 by 250 funds (17% was raised by 85 special situations funds and 9% by 43 turnaround funds). 43 of these 250 distressed private equity funds were Europe-focused funds, accounting for USD 2.2bn. out of USD 17.6bn. raised between January 2011 and August 2011, USD 5.1bn. out of USD 26.5bn. raised in 2010, USD 2.0bn. out of USD 11.9bn. raised in 2009, USD 4.3bn. out of USD 52.1bn. raised in 2008.

Distressed debt investment returns. Recent Prequin free research[5] shows impressive median net IRRs and risk-adjusted median net return IRRs for the distressed private equity asset class in general, as summed in the figures reproduced as Figure 1 and Figure 2 below.

[1] E. Altman and E Hotchkiss, Corporate Financial Distress and Bankruptcy, 3rd edition, John Wiley & Sons, Hoboken NJ, 2006, at p. 185, who estimated the distressed debt market in 2005 to be USD 600bn. at face value but USD 400bn. at market value.

[2] This is not to say that all debts issued by a debt in distress trades a discount. As indicated below, senior low-coupon long-term debt can actually trade at a premium as the debtor’s distress increases, where the seniority of the debt ensures its holders to be paid full and the perspective of a default on other debt can (through a cross-default provision) trigger the acceleration of the loan.

[3] S. Willmer, "Oaktree Seeks $4 Billion for Fund as Distressed-Debt Opportunities Expand", Bloomberg, 2 November 2011.

[4] Prequin, "Preqin Special Report: Distressed Private Equity", October 2011.

[5] Ibid.

Figure 1. Median Net IRRs per Vintage Year

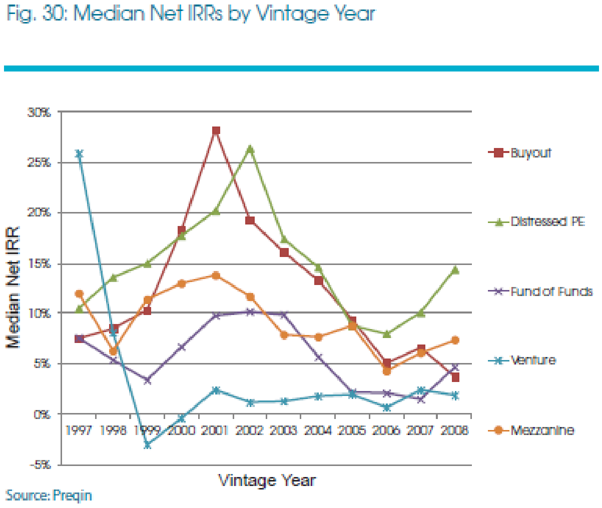
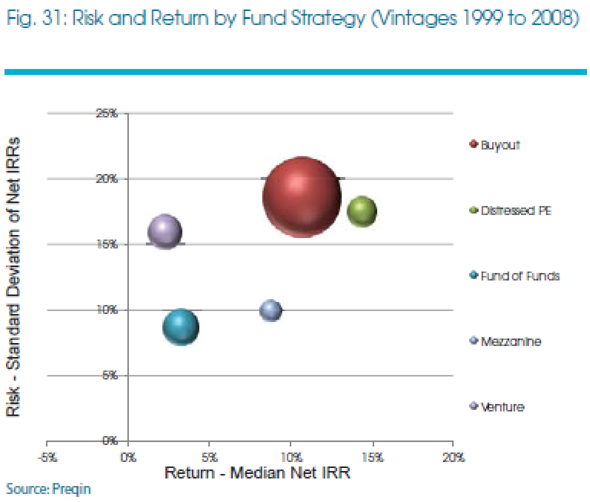


Figure 2. risk-adjusted median net return IRRs



Looking at 117 reorganizations in the U.S. over the 15-year period from 1988 to 2003, JPMorgan[6] also found that on average post-bankruptcy equities outperformed the S&P500 by 84% in the 12-month period following the reorganization (though about only half of post-bankruptcy companies outperformed the S&P500, revealing an important standard deviation).

Distressed debt investments in France. Although distressed debt investing began (and is still concentrated) in the U.S., it has spread since the early 2000s to France with investments made in debt owed by computer manufacturer Bull (debt writeoff of EUR 204m with shareholder dilution in 2003[7]), energy and transport giant Alstom (debt refinance with a new funding in 2003[8]), entertainment Eurodisney (within the context of the restructuring of the company's debt of EUR 2.4bn. in 2004, Black Diamond purchased 40% of Eurodisney's senior debt and obtained the increased by 5% of the debt's interest rate[9]), video game writer Infogrammes Entertainment SA (debt writeoff of 165m with shareholder dilution in 2006-2007[10]), channel tunnel operator Eurotunnel (debt writeoff of EUR 5bn. with limited shareholder dilution in 2006-2007 as summarised below), real estate investor Akerys (debt of EUR 220m converted into convertible bonds in holding structure entailing shareholder dilution in 2009[11]), electronics manufacturer Thomson renamed Technicolor (writeoff of debt of EUR 1.6bn. with shareholder dilution in 2009-2010[12]).

Distressed debt investments in France: Eurotunnel. In the case of Eurotunnel, for instance, 17 entities of the Eurotunnel group underwent French safeguard proceedings as from 2 August 2006 and emerged from these proceedings on 15 January 2007 with a 37-month safeguard plan calling for the discharge of slightly more than half of the EUR 9bn. debt (with senior creditors recovering 100% of their debt, junior creditors 62% and bondholders 15%) and existing stockholders retaining between 13% and 67% (depending on the conversion or redemption of the convertible bonds issued to certain creditors who had agreed to refinance the company or received these in exchange for the discharge of their debt) of the equity in a new company, Groupe Eurotunnel S.A.[13] This was quite an achievement for the shareholders in comparison to other restructurings at the time as reported by The Times[14]: shareholders at NTL received nothing, at Marconi 0.5%, at British Energy 2.5%, and at Jarvis 4.75%. In that case, the priority of "Tier 3" junior creditors over the three

[6] Thomas J. Lee, « The Chapter after Chapter 11 », J.P. Morgan Equity Research, January 9, 2004.
[7] J. Thorel, "Bull passe un premier cap vers le redressement", ZCNet France, 12 December 2003.
[8] J. Alimin, "Alstom évite le depot", Le Parisien, 23 September 2003.
[9] "Un geste pour convaincre le fonds Black Diamond", Investir.fr., 2e September 2004, accessed November 2011 via Factiva.
[10] "Infogrames poursuit la restructuration de sa dette », afjv.com, 19 March 2007.
[11] " European Distressed Debt Market Outlook 2011", January 2011.
[12] "Credit Research – European Credit Alpha", 1 October 2010, Barclays Capital" at p. 14.
[13] Judgment of the Commercial Court of Paris of 15 January 2007. For more details, see S. Gilson, V. Dessain, S. Abott, "Groupe Eurotunnel S.A. (A)", reviewed 10 March 2010, HBS case 9-209-0622, and "Groupe Eurotunnel S.A. (B): Restructuring under the Procedure de Sauvegarde", 3 March 2009, HBS case 9-209-113.
[14] A. Jameson, "Eurotunnel: Tempus", The Times, 28 October 2005, accessed via Factiva in November 2011.

classes of bondholders was not respected and bondholders were able to receive more than they should have been entitled to because the then new French safeguard law set up a credit institutions' committee, a major suppliers' committee and a bondholders' general assembly where creditors with the biggest nominal claim could vote discharges applying to creditors whose claim would otherwise have received priority.[15] Bondholders nevertheless approved the plan because they knew the asset value at liquidation had been estimated to be around EUR 1.3bn. (almost five times less than that put in the plan) so that they would receive nothing if the plan was not approved and the company liquidated[16]. Some bondholders were nevertheless able to obtain extra money in exchange for their consent to the plan and waiver of all legal actions; for instance, Oaktree Capital Management and Franklin Mutual Advisers, who had acquired together almost half of Eurotunnel's GBP 1.9bn. lower ranking Tier 3 debt, were reported to have been able to pull EUR 15m each in "underwriting fees"[17].

Distressed debt investments in France: outlook. A recent survey on European distressed debt[18] points out that of the three major world economic regions, Europe will surely remain the most stressed relative to the US and Asia and this will inevitably increase the European distressed debt market although France in early 2011 was not expected to be one of the hot spots, due to a resilient economy and banks remaining supportive of business thus not active sellers of debt[19]. With the increased popularity of this asset class and the magnitude of the funds levied, in the absence of a crisis of the magnitude of the one seen in 2008-2009 (substantial discounts were granted especially in early 2009), it is also our view that most promising investments will be in private debt (especially trade debt) in non-listed companies because of the difficulty for the competition to access it.

Plan. This paper discusses distressed debt investing in France by, after identifying (1) the market inefficiencies that enable distressed debt investors to "buy low" and (2) the effects of a reorganization on the value of the firm's assets, and discussing (2) the investment strategies available in a French legal context and consequently (3) the method for valuing a French distressed debt.

Legal rules. We have kept the discussion of the applicable legal rules to a minimum in the body of this paper. For further details on French pre-insolvency and insolvency rules, ranking of security interests in France, French legal constraints on acquiring distressed debts, and advantages and disadvantages of share deals over asset deals, please refer to the schedule appended to this paper (the "Legal Schedule").

1 MARKET INEFFICIENCIES ENABLING DISTRESSED DEBT INVESTORS TO "BUY LOW"

After (1.1) reviewing the basic risks impacting the valuation of a debt instrument, we examine the market inefficiencies that enable distressed debt investors to buy distressed debt at a lower price than its modelled value: (1.2) excess supply due to forced sellers, (1.3) limited demand due to asymmetry of information, and (1.4) illiquidity discount.

1.1 Review of the basic risks impacting the valuation of a debt instrument

A normal debt instrument will be valued according to a discounted cash flow (DCF) analysis, considering the cash flows corresponding to the interest payments and the capital repayments and discounting according to the prevailing market yield or a model yield corresponding to the free-risk interest rate for the same maturity plus premiums for (a) credit risk, (b) market risk, and (c) illiquidity risk[20], and then adjusting for the value of any built-in option[21].

[15] C. Bogie, "A priority matter", International Financial Law Review, 1 July 2007, accessed November 2011 via Factiva.
[16] J. Gounon, "Club des 30", Paris: Groupe Eurotunnel S.A., April 2008, at p. 9.
[17] A. Osborne, "Transport Eurotunnel debt rebels agree to drop action", The Daily Telegraph, 19 January 2007.
[18] Debtwire, "European Distressed Debt Market Outlook 2011", January 2011.
[19] Ibid., quoting Arnaud Joubert of Rotschield at p. 8.
[20] It goes also beyond the scope of this paper to attempt to measure a premium for the so-called "systemic risk", being the risk of collapse or dysfunctionality of financial markets through either a cascade of defaults and ultimately the default of one's counterparty or widespread illiquidity, as typically caused by massive withdrawals of deposits from banks by panicked investors: a special kind of non-diversifiable risk that cannot

To avoid any confusion, it should however be stressed at the outset that a distressed debt is not a normal debt instrument insofar as default either has occurred or is expected to occur soon, triggering the acceleration of the debt, so that we are not concerned much about the future cash flows taken into account in the calculation of the yield to maturity or the market risk corresponding to the relevant period. We are more concerned about the credit risk's loss given default component and, depending on the expected holding time of the investor's strategy (as will be seen in part 3 of this paper), the illiquidity risk. Fulcrum debt (debt that would be partly repaid in case of the sale of the company's business) will in fact be valued much more like equity. As regards the most junior debt (that would normally not be repaid in case of the sale of the company's business), its valuation will depend on the investor's possibility to use it to sell its consent to the reorganization of the company.

(a) Credit risk

Credit risk corresponds to the risk of default or (to the extent that a lender wants to dispose of a loan before its maturity or uses it as collateral) the risk of reduction in market value caused by the change in the credit quality of the relevant borrower.

Part of credit risk is idiosyncratic (what is the risk of default of this specific borrower if the market remains stable?) and part of it is systemic and could arguably be expressed as a certain beta times the market risk premium (e.g., in case of a recession, how much more is the risk of this borrower defaulting rather than this other borrower?).

Credit risk ultimately depends of (aside, of course, the size of the debt, termed "exposure at default") the debt's (i) "probability of default" and (ii) "loss given default".

(i) Probability of default (PD)

Edward I. Altman built a linear regression model in 1968 – "Z-score" model – predicting the likelihood of bankruptcy of firms based on certain key financial ratios as input variables, with different regression coefficients. The financial ratios with the highest regression coefficients turned out to be sales/total assets (0.999) followed by Earnings Before Interest and Taxes / Total Assets (0.033) whereas the Market Value of Equity / Book Value of Total Liabilities financial ratio received a regression coefficient of only 0.006.[22]

Nowadays models are categorised between (A) structural and (B) reduced-form models.[23]

(A) Structural (or firm value) models of default probability focus on the value of the borrower's assets and its liabilities.

1) The classic model of Black and Scholes (1973) and Merton (1974) – which is the root of the estimated default frequency model developed by KMV Corporation - estimates the probability of default at a time T corresponding to the maturity of the debt, looking at the expected rate of return on assets (net of debt service and distributions), asset

be appropriately measured and controlled as other market risks – a "black swan" as this term is used by Nassim Nicholas Taleb.

[21] In case of a distressed debt, a prepayment option would however a value close to zero.

[22] E. Altman and E. Hotchkiss, supra note 1.

[23] T. Bielecki, M. Rutkowski, Credit Risk: Modeling, Valuation and Hedging, Springer-Verlag, Berlin Germany, 2010. C. Bluhm, L. Overbeck and C. Wagner, Introduction to Credit Risk Modeling, 2nd edition, Chapman & Hall, Boca Raton FL, 2010. D. Duffie and K. Singleton, Credit Risk: Pricing, Measurement, and Management, Princeton University Press, Princeton NJ, 2003.

volatility, and time to maturity. The probability of default can be expressed as a percentage or in terms of number of standard deviations by which assets are expected to exceed liabilities at time T (distance to default).

2) First-passage models assume default occurring whenever the assets' value drops below a certain level (with reference to a LTV or DSCR covenant the breach of which entitles the lender to accelerate the loan). Probability of default is expressed as a default intensity, for a given time horizon.

(B) Reduced-form models of default probability determine credit events in terms of some exogenously specified jump process. These may be used to estimate default time (intensity-based models) or migrations between credit rating classes (credit migration models).

It should be added that protective covenants contained in loans (assuming they are monitored) also have a great impact on the probability of default, such as:

(A) covenants limiting the volatility of the returns of the borrower's assets (more specifically the free cash flows), such as covenants:

1) not to change the nature of the business;

2) not to sell the business, and not to acquire new businesses (at least of different types);

3) to insure assets and hedge against interest-rate changes, currency risks;

(B) covenants in respect of the capital structure, such as covenants:

1) to refrain from making distributions (dividends, repayment of subordinate debt, management fees), at least as long as certain LTV, DSCR or other ratios are not complied with;

2) to refrain from borrowing more funds at the borrower's level or at the level of a subsidiary of the latter (other than loans from shareholders bound by a subordination deed);

it being noted that these covenants, insofar as they insure that the value of the equity remains significantly positive, also indirectly limit the volatility of the returns of the borrower's assets by preventing moral hazard, namely the situation where equity holders cause the borrowing company to manage its business in a riskier way than they it would if it were all-equity financed;

(C) covenants to communicate information (e.g., quarterly financial statements…).

(ii) Loss given default (LGD)

Structural and reduced-form models can also be used to determine not only the probability of default but also the expected recovery rate in case of default.

In addition to the protective covenants, the impact on LGD of (A) collateral, (B) external credit enhancers, (C) contractual subordination, (D) maturity structure, and (E) corporate structure must also be considered when valuing LGD.

(A) Collateral

Collateral consists in in rem security interests ("security interests in the asset") given over the borrower's assets[24], enabling a lender to be paid out of the proceeds of the sale of such assets in priority to other creditors, save those creditors which the law gives some priority (in essence, depending on the jurisdiction, the type of proceedings, and the type of collateral: wages, taxes, and receivables incurred during insolvency proceedings (see more details on rankings in part 2 of the Legal Schedule).

(B) External credit enhancers

External credit enhancers include:

1) parent guarantees, which may themselves be secured by collateral belonging to the parent[25]: their value depends on the PD and LGD in relation to that parent;

2) parents' undertaking to make capital contributions to the borrower so that the latter may satisfy its investment, operating, and/or financing cash flow needs;

3) credit insurance, including any insurance purchased in the from of a credit default swap.

External credit enhancers are particularly helpful in periods during which information asymmetry is high, such as during the pre-completion period of a project when no positive free cash flows are generated.

(C) Contractual subordination

Contractual subordination has the same effect of collateral: it allows a lender to be paid in priority to another creditor who agreed to be subordinated.

(D) Maturity structure

Maturity structure allows creditors whose debt matures first to be paid in priority to creditors whose debt matures later, the latter being used as credit support for the former (assuming the latter does not contain a cross-default clause so that default under the former is default under the latter).

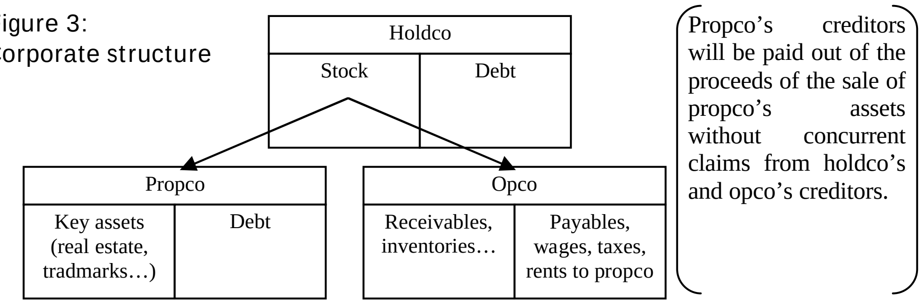
(E) Corporate structure

Corporate structure allows creditors who lent to a subsidiary owning the key assets of the business ("propco") to be paid in priority to the creditors who lent to a holding company ("holdco") or to an operating company ("opco") which does not own but rents or

[24] In rem security interests may take the form of either "fixed" charges that attach only to existing collateral (not future collateral) and generally remain attached even after the collateral is sold to a third party in breach of a covenant, or "floating" charges that attach to not only existing but also future collateral but which does not remain attached to collateral that is disposed of before "crystallization" of the charge (following default).
[25] Parent guarantees can also take the form of in rem security interests granted by a parent over that parent's assets as security directly for the borrower's loan.

licenses the key assets of its business from the propco, as illustrated in Figure 3 below.

Figure 3:
Corporate structure



(b) Market risk

Although credit risk and liquidity risks can be viewed as components of market risk, market risk also includes the risk of an increase in interest rates (in absolute terms or relative to the interest rate under the relevant loan); the longer the maturity and the lesser the coupon, the greater this risk.

(c) Illiquidity risk

Liquidity risk corresponds to the risk of loss for not being able to dispose of a debt before its maturity at a fair market value.

Arguably, like credit risk, part of illiquidity risk is idiosyncratic (what is the current liquidity of this given investment?) and part of it is systemic and could be expressed as a certain beta times the market risk premium (e.g., in case of recession and ensuring flight to liquidity, how much will this illiquid investment become even more illiquid compared to another?).

Liquidity risk results from:

(i) transaction costs, including both:

(A) direct transaction costs such as any fee payable to a broker, any due diligence costs, and

(B) indirect transaction costs such as the "unwind" fee corresponding to any bid-ask spread;

(ii) the non-diversification of investors, namely, with reference to the capital asset pricing model, the increased beta expected from investments which investors are forced to overweigh in their portfolio, such as family business owners with respect to shares in their company or Swiss investors with respect to Nestle restricted registered shares prior to 1988 (which traded to a circa 50% price discount compared to Nestlé bearer shares[26]) – this is illustrated in Figure 4 below.

[26] Loderer, C., Jacobs A., "The Nestlé Crash", Journal of Financial Economics, 1995, 37, 315–339. Stulz, R.M., Wasserfallen, W., 1995. Foreign equity investment restrictions, capital flight, and shareholder wealth maximization: Theory and evidence. Review of Financial Studies 8, 1019–1057.

Figure 4. Additional yield premium expected from an investment not available to fully-diversified investors

This premium corresponds to the difference between $E(r_{DD'})$ and $E(r_{DD})$ where

$$E(r_{ND}) = r_F + ß_{ND}(r_M-r_F) \text{ and } E(r_D) = r_F + ß_D(r_M-r_F)$$

and where:

"$E(r_{ND})$" corresponds to the expected rate of return of a given investment for non-fully-diversified investor;

"$E(r_D)$" corresponds to the expected rate of return of a given investment for a fully-diversified theoretical investor;

"r_F" corresponds to the risk-free rate of return;

"(r_M-r_F) corresponds to the market premium;

"$ß_{ND}$" corresponds to the covariance between the returns of a given investment and the returns of all assets making up the portfolio of a non-fully-diversified investor, divided by the variance of the returns of all assets making up the portfolio of a non-fully-diversified investor;

"$ß_D$" corresponds to the covariance between the returns of a given investment and the returns of all assets (using stock market as proxy), divided by the variance of the returns of all assets (again using stock market as proxy).

1.2 <u>Excess supply due to forced sellers (especially just after the debtor's distress becomes apparent)</u>

Some debt holders are forced - or irrationally decide – to sell their debt when they find out it has become distressed debt, and are prepared to grant a more important price discount than would be justified by the debt's combined credit risk, market risk, and even liquidity risk, it being noted that, according to distressed debt investor Stephen G. Moyer (who wrote a very practical book on the topic[27]), supply is especially strong just after a significant negative information event making the debtor's distress or potential distress becomes apparent or as a significant near-term liquidity requirement approaches with no news of the debtor having found refinancing.

These distressed debt sellers include:

(a) ratings-focused credit mutual funds constrained by mandates setting minimum credit ratings for the debt hold by them;

(b) collateralized debt obligations (CDOs) constrained by the requirements of arbitrary valuation rules;

(c) commercial banks for whom holding an impaired loan becomes too expensive in terms of risk capital allocation, with reference to the amount of nonperforming loans maintained on their balance sheet,

(d) banks having internally overly written down the value of an impaired loan (although some bankers may delay taking a write-down) before transferring it to their workout team, creating an incentive for the latter team to dispose of it as soon as possible for a price that matches its overwritten down value;

[27] S. Moyer, Distressed Debt Analysis: Strategies for Speculative Investors, J. Ross Publishing, Boca Raton FL, 2005 at pp. 240-241.

(e) banks not willing to hold debt likely to be swapped into equity as a matter of policy or business strategy or just because of internal politics (the investment would move to the bank's equity investment team);

(f) trade creditors who need the money fast.

1.3 Limited demand due to asymmetry of information (especially just after the debtor's distress becomes apparent)

Although the size of demand for distressed debt varies according to the amount of "dry powder" of funds formed to invest in distressed debt opportunities, it is constrained by asymmetries of information.

Demand diminishes as asymmetries of information increase; when only a limited number of investors have both access to (a) company-specific information and (b) the financial and legal knowledge to process this information and come out with a valuation of a distressed debt given the likelihood of different legal process outcomes, only they will dare offer a price close to the "true" value whereas the others will likely bid lower prices, integrating in their discount rate a higher "lemon's premium" corresponding to the risk of ignoring material adverse information the seller has. Such asymmetries of information are at their strongest just after the debtor's distress becomes apparent and diminishes afterwards as the information diffuses; consequently demand potentially increases as time passes.

(a) Company-specific information

This includes:

(i) the company's recent or pro forma accounting information (balance sheet, P&O, cash flow statement), it being noted that management is usually reticent to communicate on deteriorating financials whereas existing lenders usually have an edge to the extent that they must usually receive communication of semi annual or quarterly financial information pursuant to loan covenants;

(ii) particulars of its capital structure, more specifically the exact terms of all bonds issued and bank debt borrowed (subordination, security package, which debt matures first, where the debt sits exactly in case of consolidated accounts…):

(b) Financial and legal knowledge

The financial and legal knowledge to process this information and come out with a valuation of a distressed debt given the likelihood of different legal process outcomes supposes the ability to answer these questions:

(i) in the absence of insolvency proceedings, what proceeds would the debt holder expect by accelerating the debt and, if secured, by enforcing security interests, in the light of the remedies available under local law to creditors and debtors and complexity of certain subordination agreements?

(ii) What are the prospects of the creditors agreeing to an out-of-court restructuring deleveraging the company for the benefit of all or what kind of insolvency proceedings may be opened and where? How would this impact on the value of the firm's assets (the "size of the pie") given the possibility of a court-ordered reorganization with an optimum capital structure (i.e., after writing off part of the debt and possibly converting it into equity) and increased return on invested capital (through disposal of non-operating assets, divestment of low-ROIC divisions, reduction of operational costs, unnecessary capital expenditures, and excess working capital requirement… which may require the removal of management)? How would this impact on the ranking of the distressed debt compared to the ranking of the claims of other creditors (how is "the pie cut") and whether the investor can capture a greater share of the firm's assets through uncooperative, sale, or loan-to-own strategies?

For example, certain trade creditors might believe that their debt is worth close to nothing because they assume the value of the firm's assets (even after eliminating most of the financial distress costs and agency cost) will be completely captured by secured creditors. They might not realize subtleties in the corporate structure of the group giving them priority on the assets of the operating company while secured creditors might hold debt against another company within the group. A distressed debt investor may consequently end up buying their debt for a very low price.

1.4 Illiquidity discount

Investors interested in holding the debt throughout the reorganization process can benefit of an illiquidity discount that is called to diminish after the reorganization process.

This illiquidity discount results not as much from direct transaction costs but from:

(a) indirect transaction costs or "unwind" fees corresponding to the bid-ask spread; although we do not have data enabling us to asses the typical bid-ask spread, Stephen G. Moyer (2004) cites distressed bonds trading in a 29-bid/30-offer context whereas reporting that this actual bid-ask spread may be as narrow as on-the-run high-yield bonds for large actively traded fallen angels or much wide for less traded bonds, and point out that the relatively smaller market awareness of companies with a total capitalization of less than USD 500m result in their debt being more likely to be misvalued but this illiquity may also make it difficult for the investors to acquire the desired position[28] ;

(b) arguably the fact that distressed debt investors acquire big chunks of distressed debts against those few borrowers which they studied well and (except for passive investors) in which the invest time and efforts through their reorganization process, result in distressed investors to overweigh in their portfolios their investments in distressed debts – it is however beyond the scope of this paper to dwell further this hypothesis in the light of the counter-argument that many distressed debt investors are funds in which fully-diversified investors may invest.

Further to the reorganization, bid-ask spreads tend to diminish and investors who could not invest in distressed debts (because of mandate constraints, risk-allocation rules, the difficulty in assessing the value of distressed debts…) can now buy the debt (or the new debt or equity it was swapped for), participating in the price increase reported in the above-cited JP Morgan paper[29].

2 How the reorganization of a debtor's business may increase enterprise value

This section examines how a reorganization, whether in the form of an out-of-court restructuring or under a court-ordered plan, may increase the market value added ("MVA") of a debtor's assets, which corresponds to the difference between the enterprise value[30] and the capital employed, or put another way the present value of the expected economic value added ("EVA") for all future periods, the EVA for each period being calculated as follows:

$$EVA = (ROIC - WACC) \cdot \text{invested capital}$$

[28] S. Moyer, supra note 27, at pp. 39-41 and pp. 240-241.
[29] Supra note 6.
[30] Enterprise value being the firm value plus the value of any non-operating assets, and firm value being the present value of future free cash flows. An efficient company should have no non-operating asset so the shortcut to firm value when actually speaking of enterprise value can be made for ideally-managed firms.

where "ROIC" means the after-tax return on invested capital and "WACC" means the weighted average cost of capital.

It follows that value can be created by increasing ROIC, lowering WACC, or (provided that ROIC exceeds WACC, which supposes that the company is not in distress in the first place!) increasing invested capital by reinvesting retained earnings or raising external capital.

Another angle is to examine how enterprise value (V_T), which corresponds to the sum of the actual value of debt (V_D) and the actual value of equity (V_E), could be maximised by reducing financial distress costs and agency costs.

For simplification reasons, this paper generally assumes that any increase in V_T is impacted on V_D until V_D reaches its potential maximum, any further increase in V_T being impacted on V_E. The reality is more nuanced to the extent that holding equity is like being long a call option on the assets of a company with a strike price equal to the amount of debt and holding debt is like owning such assets but writing such call option; consequenlty, depending on the volatility of enterprise value (which depends on the combined idiosyncratic and systemic riskiness of the company's business) and long-term character of the debt, the nearer V_T to the amount of debt, the more any variation in V_T will impact both V_D and V_E.

It follows that value can be created for debt holders by (2.1) decreasing financial distress costs (which impact both WACC, ROIC, and invested capital) and (2.2) agency costs (which mostly impact ROIC).

2.1 How reorganization may decrease financial distress costs

Reorganization may decrease financial distress costs in terms of both (a) WACC, (b) ROIC, and (c) invested capital.

(a) Decreasing WACC

WACC can normally be calculated according to the following formula:

$$WACC = [(1- t_C)\cdot k_d\cdot D/(E+D)] + [k_e\cdot E/(E+D)]$$

where "k_d" means the before-tax cost of debt (i.e., the forward-looking cost of new debt), "t_C" means the effective marginal tax rate, "k_d" means the cost of equity, "D" means the market value of debt, and "E" means the market value of equity. A company in financial distress will typically have had an optimum current leverage ratio of D/E ("ϕ") at one point in time but, further to the diminishing of its expected free cash flows but not the level of its indebtedness:

(i) the increased credit risk for the lenders translated into a higher before-tax cost of debt (though not a greater market value of debt);

(ii) accumulated tax losses (that can be offset against future taxable profits) caused the after-tax cost of debt to cease to be cheaper than the before-tax cost of debt (t_C = 0%);

(iii) the cost of equity also increased as the financial risk increased not only with the amount borrowed but the interests payable on that sum[31];

[31] According to the capital asset pricing model, cost of equity (k_e) corresponds to the expected rate of return of equity ($E(r_E)$) given the following equation: $E(r_E) = r_F + ß_E(r_M-r_F)$, where $ß_E$, the levered beta of equity, corresponds to the covariance between the returns of borrower's equity - given both its business and financial risk - and the returns of all assets (using stock market as proxy), divided by the variance of the returns of all assets (again using stock market as proxy), and "(r_M-r_F)" is the market premium. Hamada's equation, which combines the capital asset pricing model with the Modigliani-Miller theorem, calculates the levered beta of equity as follows: $ß_E = ß_A[1+(1-t_C)\cdot D/E]$, where $ß_A$, the unlevered beta of equity or beta of assets, corresponds

(iv) arguably both the cost of debt and the cost of equity further increased by a "lemon's premium" (a term first used by Akerlof) being charged by new capital providers to the extent that asymetries of information tend to be greater in companies in financial distress.

With financial costs increasing the cost of debt and to a lesser extent the cost of equity, a minimum WACC depends an optimum ϕ, which ideally should be such that the marginal increase in the interest tax shield that would be obtained by increasing debt further would be offset by the additional (progressive) distress costs. (The optimum ϕ should vary in time because a distressed company will typically have no need for an interest tax shield in its first years of recovery as it can offset its previous tax losses against its taxable profit; as it uses up its tax losses, increasing its leverage becomes more interesting because of the benefit of an interest tax shield.)

Consequently, a reorganization can create value by "deleveraging" the capital structure of a distressed company, which consists in obtaining the discharge of some of the debt or buying it back at a discount.

Deleveraging should take place at two levels:

(i) First-level deleveraging

If the amount of debt exceeds the value of the assets, it is possible to discharge the excess debt without materially affecting its market value. Because holding debt is like owning the assets but writing a call option on the assets for a price equal to the amount of debt, the resulting diminution in the market value of the debt will be equal to the difference between the value of the "at the money" option as the value of the assets now equals the amount of debt after partial discharge and the value of the "out of the money" option when the value of the assets was clearly below the amount of debt. Ideally the discharged debt should be converted into equity worth this diminution in the market value of the debt.

(ii) Second-level deleveraging

Once we have reduced the amount of debt to match the value of the assets, we should normally go farther in decreasing the amount of debt so as to materially reduce D until ϕ reaches a level where WACC is at or below its potential minimum, namely such ϕ that any marginal increase in D would not generate enough interest tax shield (assuming the company has become profitable again) to offset the additional (progressive) distress costs, which correspond to an higher cost of debt (which can be easily modelled) plus the negative impact on ROIC discussed below. (With plenty of tax losses to offset against future taxable profits, ϕ could be temporarily reduced below that long-term optimal level.)

The discharged debt should be converted into equity worth the diminution in the market value of the debt, which should correspond to the amount of the reduction of debt below the value of the assets plus (unless de minimis)

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to the covariance between the returns of borrower's equity given its business risk (but excluding its financial risk) – which correspond to the returns of the borrower's assets – and the returns of all assets (using stock market as proxy), divided again by the variance of the returns of all assets (again using stock market as proxy. Hamada's equation however not only assumes that financial risk depends only on the current leverage ratio of D/E whatever the cost of debt, it also underestimates the financial risk by assuming that cost of debt is always equal to the risk-free rate of return[31]. A constant ϕ over time is also assumed. R.D. Cohen ("Incorporating default risk into Hamada's equation for application to capital structure", Wilmott Magazine, 2007, p. 67) recently proposed the following modified version to the Hamada's equation, replacing D by D*: $ß_E = ß_A[1+(1-t_C)\cdot D^*/E]$, where $D^* = (k_d/r_F)\cdot D$ (i.e., the present value of the interest payments ($k_d\cdot D$) discounted at r_F).

the difference between the value of the "in of the money" option after reducing the amount of debt and the value of the "at the money" option when the value of the assets was equal to the amount of debt.

(b) Increasing ROIC

Without necessarily going so far as to replace management and improve corporate governance so as to diminish in the long term any agency cost that may have limited the ROIC until now, a reorganization may improve ROIC by:

(A) to the extent that the reorganization is agreed in an out-of-court settlement, avoiding the direct costs of financial distress corresponding to lawyer fees and fees of the judicial administrator and creditors' representative appointed in insolvency proceedings;

(B) terminating leases and other long-term contracts that were saddling the company with too great a financial burden in the light of the value they created for the company, including employment contracts;

(C) disposing of non-operating assets as well as fixed assets generating returns below WACC, including any division that would be better run by a potential (possibly strategic) acquirer who would be ready to value it greater (given any synergy and the absence of agency costs relating to the current management);

(D) improving (i.e., reducing) working capital requirement as suppliers are less scared of giving credit to a company on the verge of insolvency, and clients are less scared of paying in advance;

(E) improving sales as less potential clients refuse to buy out of fear that the company closes business and is not able to deliver, not only the promised services or goods that were paid for, but also any post-delivery services or goods (e.g., spare parts, maintenance).

(c) Maintaining invested capital

A reorganization may cease financial distress costs taking the form of:

(i) the suspension of a capital expenditure programme that would have created value or, worse, that is key to the sustainability of the company's business model (translating in a competitive advantage loss);

(ii) the disposal of assets at a price below their market value because they are illiquid or the sale of a whole division for a price not reflecting the value of the synergies that such division created for the firm or, worse, assets or businesses that were key to the business model of the company (translating in a competitive advantage loss).

2.2 How reorganization may decrease agency costs

Reorganization may decrease agency costs when accompanied by a change of control.

Control allows one to replace "bad" management and possibly improve corporate governance over new management (through a board of directors where the investor sits), enabling the business to maximise its ROIC through:

(a) the disposal of non-operating assets,

(b) better management of operational expenses, less perks,

(c) better management of the working capital requirement,

(d) perhaps better top line management by market/product developments and better segmentation of the market.

The seller of a controlling equity position would normally be aware of this and charge accordingly a so-called "control premium" (for instance, KKR was willing to pay a price for the shares in RJR Nabisco Inc. that was much greater than the price the stock was trading it before its bidding war with John Ross and his MBO partners, which reflected a return on invested capital saddled with excessive perks including corporate jets). Sellers of distressed debt however do not necessarily realize that the holder of fulcrum debt could ultimately swap it for a controlling equity interest in the firm, hence charge no control premium.

3 Investment strategies available in a French legal context

Distressed debt investment strategies can be broken down into three: (2.1) passive investments (which focus on "buying low"), (2.2) active investments not aiming control (which rely on both "buying low" and reduction of financial distress costs), (2.3) active investments aiming control (which also rely on reduction of agency costs).

3.1 Passive investment strategies

These strategies involve "buying low" distressed debts, with or without hedging, and then passively wait for the market price of the distressed debt to go up (if it is traded) and sell it when it has reached a market value conforming with its modelled value and ideally when the illiquidity discount has lost its raison d'être, or just wait for it to be paid by the debtor.

Altman and Hotchkiss[32] report that this strategy, in the U.S., typically involves an exit within 6 months to 1 year generally, sometimes longer, and a target return of 12% to 20% p.a. He reports for instance that in 2003 passive investors were able to achieve target returns of as much as 50% on CCC debts that ended up defaulting and gaining in value, 80% on defaulted bonds.

The rationales for this strategy are mainly the presence of the market inefficiencies discussed in part 1 of this paper: excess supply (diminishing as forced sellers exit), limited demand due to asymmetries of information (diminishing as information spreads), illiquidity discount (diminishing as the distress situation disappears further to the reorganization of the debtor, be it only a deleverage and optimisation of its capital structure).

It should be noted at this stage that money may also be made by buying senior low-coupon long-term debt trading at par to the extent that, as the debtor's distress increases, the more likely the perspective of a default on other debts and (through a cross-default provision) the possibility for the debt holder to accelerate the loan, hence increasing the present value of the repayment cash flows (provided that the seniority of the debt ensures its holders to be paid full).

Further developments below deal with (a) hedging including through "capital structure arbitrage" and (b) problems specific the resale of the debt to the borrower itself or an associate thereof.

(a) Hedging including through capital structure arbitrage

Investing in distressed debt can be hedged through a variety of techniques:

(i) buying a credit default swap in respect of the very entity or an entity in the same industry which is likely to go bust at the same time as the issuer of the distressed debt;

(ii) realising so-called "capital structure arbitrage" short sales.

[32] E. Altman and E. Hotchkiss, supra note 1, at p. 189.

The latter technique is very peculiar to distressed debt investments. It consists in, when purchasing distressed debt (which may be trade claims) at a more important discount, short selling bond or stock issued by the same company and trading (short selling supposes trading debt) at a lower discount than the distressed debt just acquired. This other bond or stock may be:

(i) a bond ranking pari passu but trading at a greater price because of a shorter (Macaulay) duration (resulting in lesser market risk) or because of greater liquidity (e.g., as compared to illiquid trade claims acquired by an investor); in case of insolvency filing, the price of the bond that was short sold will likely decrease more than the price of the pari passu distressed debt, as the likelihood increases of both debts being paid at the same time and in the same proportions;

(ii) a bond trading at the same price and having only the appearance of ranking pari passu but which the investor considers as having a greater LGD (e.g., a bond issued by an holding company with no assets other than the stock of the operating company it acquired and which has issued the distressed debt that is purchased by the investor);

(iii) a bond of a different seniority, or even a stock, that the investor considers to be insufficiently discounted compared to the discount of the debt it wishes to acquire, taking into account the likelihood of a refinancing event or acquisition and the resulting likely (expected) price increase and the likelihood of an unsuccessful reorganization or outright liquidation and the resulting likely (expected) price decrease.

(b) Resale of the debt to the borrower itself or an affiliate thereof

We examine hereafter (i) the business model relying on the resale in bulk to a debtor of debt collected from various creditors and (ii) the advantages of reselling debt to an affiliate of the debtor rather than the debtor itself.

(i) Business model relying on the resale in bulk to a debtor of debt collected from various creditors

We have become aware through the INSEAD community of a specific business model consisting in acquiring at a discount small slices of bond debt from various bondholders and then offering to the borrower to repurchase this debt, or have an affiliate thereof repurchase it, at a lesser discount.

This business model relies on two key elements in my view:

(A) the lower opportunity cost for individual selling bondholders who make the saving (in terms of transaction costs) of spending time and costs:

1) assessing the approximate value of the debt: the selling bondholder, relying on the reputation of the investor, trusts that the price offered by the latter for the bond is not excessively discounted compared to the true value of the bond;

2) having a lawyer draft and negotiate the terms of any sale offer and the resulting contractual documentation and formalities (in France a debt transfer must be formally notified by huissier to the debtor in order to be effective against third parties including the tax administration, at the cost of approximately EUR 100): the distressed debt investor

takes care of it and realises economies of scale.

(B) the increased "willingness to pay" of a debtor (to whom the debt is resold) who sees:

1) the possibility of buying at a discount greater than the one it could have negotiated with the original bondholders, who would have probably not accepted to sell at the price they sold to the investor if the borrower had offered them such price, for information asymmetry reasons (e.g., "the debtor knows better than I its financial situation so the price he's offering me is surely too low") and emotional reasons (e.g., "the bastards have the guts to offer me a lower price than the amount they committed to repay");

2) the economies of scale in terms of transaction costs as the debt slices are bought in bulk;

3) possibly the lower transaction costs for structuring the transaction in a tax efficient way as described below.

(ii) Advantages of reselling debt to an affiliate of the debtor rather than the debtor itself

There are essentially two advantages of reselling debt to an affiliate of the debtor rather than the debtor itself (it being noted that we have seen this strategy implemented in many files we are not authorised to disclose as lawyers):

(A) (provided that the affiliate is solvent) this avoids the risk of the transaction being annulled later on if the debtor is found to have been in a state of cessation of payment at the time of the transaction, as any payment made by a debtor in a state of cessation of payment is void;

(B) it is possible to structure the transaction so that the debtor does not have to record a taxable gain resulting from cancellation of debt ("COD") whereas any gain realized by the affiliate (to the extent that it is able to obtain more capital repayments and interest payments than the price it purchased the debt) can be tax free or taxed at a very low rate if the affiliate is incorporated in a tax-friendly jurisdiction such as Luxembourg.

Indeed, like when a debtor repays part of its debt with the balance being forgiven, when a debtor repurchases the debt it owes at a discount, the resulting cancellation of debt ("COD") is taxable income in France although it may be offset with current year and previous years' losses.[33]

This being said, notwithstanding the tax disadvantage, a borrower might wish to purchase itself the debt only for the purposes of improving its accounting result, so as to meet any interest coverage ratio or other financial covenant (e.g., Endemol repurchased in 2009 part of its LBO debt at a discount and realised a EUR 80m gain that it added to its IFRS operating benefit, thus improving loan financial

[33] There is in France no exception to this rule similar to the exceptions set out in section 108(a) of the U.S. Internal Revenue Code, which enables a company to avoid COD income even for an amount exceeding its current year and previous years' net operating losses (other tax attributes are reduced for the remainder, extending to any tax group). This U.S. advantage is however usually not material as many insolvent companies will have enough previous losses to offset any COD income.

ratios; after the other lenders contested this accounting treatment, Endemol promised not to record future profits of this type into IFRS operating benefit[34]).

3.2 Active investment strategies not aiming control

An active investment strategy not aiming control will simply rely on the combination of "buying low" and, depending on how the distressed debt of the investor ranks, either (a) facilitating the reorganization of the debtor's business or (b) blocking it until the other debt holders and stockholders agree to "buy" the investor's consent, and (c) possibly extending an existing loan or participating to a debtor-in-possession loan.

Altman and Hotchkiss[35] report that this strategy, in the U.S., typically involves an exit within 1 to 2 years and a target return of 15% to 20% p.a.

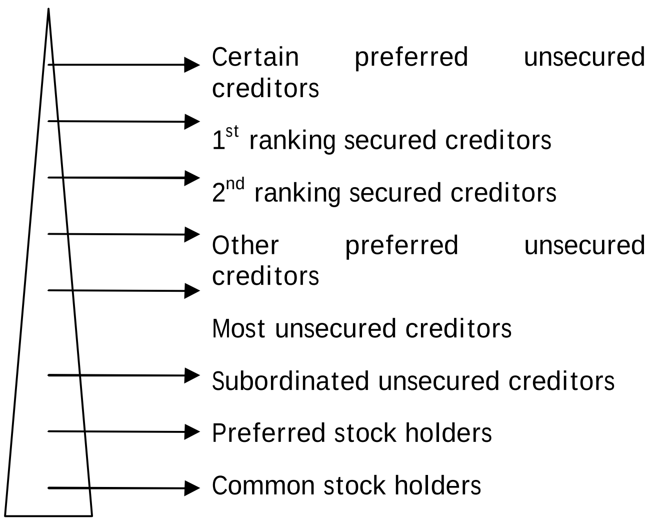
In this regard, the presence of another distressed debt investor accumulating a position in a debtor may be a positive factor for a distressed debt investor not aiming for control inasmuch as, beyond this presence bringing comfort to the second investor's judgment about the investment opportunity, the second investor may piggy back the former by having the latter take the most active role in the negotiations… provided the two have the same class of debt hence pursue the same strategy.[36]

(a) Facilitating the reorganization of the debtor's business

A distressed debt investor who owns the so-called "fulcrum securities" will normally be the stakeholder who will first benefit from the increase in value resulting from the reorganization of a debtor's business, as being the "next in line" in the waterfall of value distribution from senior secured debt holders down to common stock holders.

"Fulcrum securities" correspond to those (typically debt) securities that would be partly repaid if the debtor's assets were sold under liquidation proceedings and the proceeds were distributed among creditors and stockholders according to their ranking, which can be classified for simplification purposes as indicated in Figure 5 below.

Figure 5. Gross classification of creditors and stockholders



[34] F. Anselmi, "Les rachats de dette ne doivent plus influencer les ratios bancaires", Agefi.fr, 8 April 2010.
[35] E. Altman and E. Hotchkiss, supra note 1, at p. 189.
[36] S. Moyer, supra note 27, at p. 241.

The reality is of course more complex as each creditor may rank differently regarding each asset, given the type of insolvency proceedings and type of sale (see the Legal Schedule for further details on the ranking of the different security interests in France).

Typically, unless the business is sold (and creditors paid according to their priority rank), a reorganization will lead to the most senior creditors being paid in cash for the full amount and the fulcrum creditors receiving equity or more likely convertible bonds (the junior creditors receiving nothing unless they were had some power to block the reorganization). This is because, in a context where equity holders will seek the maximum debt writeoff claiming that the enterprise value is very low and where fulcrum creditors will seek the greatest recovery possibly arguing that enterprise value is not as low as claimed by equity holders, paying the fulcrum security in stocks (or stock options, or any other form of upside interest in the future cash flows of the company) will increase the odds of the parties' finding an agreement on the amount of the debt discharge.

If a distressed debt investor holds all or a substantial portion of the fulcrum securities, then he could take an active role in the reorganization process by promoting either (i) an out-of-court restructuring, (ii) a pre-packaged plan of reorganization, (iii) a "cram-down" plan of reorganization, or (iv) the sale of the business.

(i) Out-of-court restructuring

An out-of-court restructuring, possibly in the context of confidential conciliation proceedings in France, has the advantage compared to a safeguard or judicial reorganization proceeding of not further increasing financial distress costs in the form of:

(A) legal proceedings costs greater in safeguard or judicial reorganization proceedings;

(B) suppliers' refusal to grant credit to a company undergoing a safeguard or judicial reorganization proceeding, increasing working capital requirement;

(C) customers' refusal to prepay products or services from a company undergoing a safeguard or judicial reorganization proceeding, increasing working capital requirement, it being noted that customers may even refuse to buy at all products or services that require long-term assistance or spare parts from the company if they had concerns it may cease business.

An out-of-court restructuring however requires the support of any creditor whose claim is to be partially or fully forgiven or postponed for the greater benefit of all stakeholders.

This situation is akin to the prisoner's dilemma, where cooperation is in the best interest of the creditors as a group because the restructuring will increase the enterprise value but each individual creditor's personal interest is to refuse to participate.

To a certain extent, the fact that the community of distressed debt investors active in a certain area is relatively small may compel its members to act "fairly" (i.e., by agreeing that holders of the fulcrum securities should mainly benefit from the extra value created by the reorganization, and junior lenders should be the one whose claim should be substantially fully discharged) because of the likelihood of co-investing in the another company in the future.

(ii) Pre-packaged plan of reorganization

A pre-packaged plan of reorganization is similar to an out-of-court restructuring in that it requires the consent of all participating creditors to deleverage the capital structure, but they agree to nevertheless place the company under pre-insolvency or insolvency proceedings (in France: safeguard or judicial reorganization proceedings) for a very short period in order to benefit from a more favourable regime for terminating long-term contracts - including excessive employment contracts – negatively affecting ROIC.

A pre-packaged plan of reorganization will be favoured to an out-of-court restructuring where the benefit of these measures for improving ROIC will outweigh

(A) the extra costs of filing such pre-insolvency or insolvency proceedings, which would be limited to the extent that said proceedings are not supposed to last for more than a few days;

(B) the harm done to client and supplier relationships (translating into greater WCR and lesser ROIC) by the knowledge that the company underwent, albeit for a short period, such pre-insolvency or insolvency proceedings.

For instance, General Motors pursued a prepackaged plan of reorganization backed notably by the U.S. Government, its greatest creditor (a debt of USD 19.4bn. whereas GM's assets were worth USD 90bn), who had agreed in advance to grant a DIP loan of USD 24.2bn. and purchase, through a newly formed company that would become known as the "New GM", in a highly controversial 363 sale, the most profitable assets (includig Chevrolet, Buick, GMC, and Cadillac), whereas the less profitable assets (Pontiac, Saturn) remained in the old company, which was liquidated with the aid (USD 1.2bn) of the U.S. treasury. Creditors would also received partial recoveries in common stock of "New GM". The company filed for bankruptcy on 1 June 2009 and by July 2009 the transfer was realised.[37]

CIT Group also filed on 1 November 2009 a voluntary bankruptcy petition under a prepackaged debt restructuring plan calling for a USD 10bn. debt reduction. It emerged from bankruptcy in December 2009 with USD 10.4bn. less debt, the cancellation of its preferred stock and prior common sotck interests, the issuance of 2000 million new common shares, and a 3-year extension to the maturity of some of its debt.[38]

In France, in the Eurotunnel case, management attempted to pursue a prepackaged plan of reorganization but chairman and CEO Jacques Gounon's outright demand for a writeoff of more than half of the EUR9bn. debt with equity holders retaining a substantial interest was not well received, so in the end he filed for safeguard proceedings and negotiated with the biggest holders of debt voting in the different creditors' committees and bondholders' assembly, as mentioned above.

(iii) Cram-down plan of reorganization

A cram-down plan of reorganization may be used when all creditors and equity holders cannot agree on an out-of-court restructuring or pre-packaged plan of reorganization. It consists in a plan of reorganization

[37] H. Nesvold, J. Anapolsky, A. Lajoux, The Art of Distressed M&A, McGraw Hille, New York NY, 2011, at pp. 80-82.
[38] Ibid., at p. 82.

where the capital structure is deleveraged by forcing certain debtors to forego their debt against their will.

In the U.S., it is possible to implement a cram-down plan of reorganization provided that:[39]

(A) the more senior creditors be paid in full before more junior creditors receive any recoveries (the absolute priority rule), and

(B) each individual creditor receive a stake that exceeds the amount such creditor would receive in an hypothetical liquidation scenario, assuming the debtor's whole business was sold as a going concern to a third party and the net proceeds (after subtracting liquidation costs) were allocated to the various classes creditors (the best interests of creditors test).

In France, whether the company is undergoing safeguard or judicial reorganization proceedings, it is also possible to cram-down certain junior creditors but not all of them. Indeed, as discussed in the Legal Schedule and below, only creditors belonging to a creditor's committee or bondholders who are junior to other bondholders can be crammed down (the vote is taken at a majority corresponding to at least 2/3rds of the amount of the claims of the creditors who took part to the vote, unaffected senior creditors not voting). Others may insist on being fully paid albeit according to a court-ordered instalment plan than can last up to 10 years after the plan is adopted.

In order to increase the likelihood of a cram-down plan being approved by the court, one must generally:

(A) negotiate with the equity holders a sufficient discharge of the overall debt (through essentially a reduction of the debt corresponding to the fulcrum securities) so that they agree to present the plan to the court (in the U.S.) or creditors' committee (in France), given that they have the initiative of proposing a plan of reorganization and, even as regards a plan proposed by creditors, it has better chances of being approved by the court if backed by the equity holders (see the part 1 of the Legal Schedule for a discussion of the role the debtor in presenting solutions to creditors compared to the U.S.' "exclusivity period");

(B) talk certain senior creditors into approving the plan, especially senior creditors who have enough collateral to pay up their claims even in a liquidation scenario (entailing the sale of the assets at their foreclosure value, rather than at their higher going concern value) hence might prefer the liquidation scenario as it would entitle them to immediate payment.

(iv) Sale of the business

In countries such as France where cram down may be difficult to realize, one solution consists in having the business sold after having improving its operations, provided that a purchaser can be found who can offer a price corresponding to the potential value of the assets including any premium a strategic investor would be ready to pay for any synergies.

This solution would indeed insure that the value of the assets is justly distributed among the creditors according to their order of priority (with, in

[39] Ibid., at pp. 333-371.

France, certain secured creditors getting even a better ranking in case of a sale of a business than they would have in case of the sale of the collateral asset individually – see part 2 of the Legal Schedule).

Although not impossible to find, it is usually difficult to find such an ideal purchaser in a short time frame, with most buyers of distressed businesses looking for a bargain and the advertising of distressed businesses for sale not being very transparent in France (each of the local commercial courts maintain its own ads). At the end of the day, this solution may therefore not necessarily be better than a plan of reorganization for maximising value to distressed debt investors.

(b) Blocking the reorganization of the debtor's business until the other debt holders and stockholders agree to "buy" the investor's consent

Another strategy particularly liked by "vulture" funds, as distressed debt investors are sometimes described by the French press, consists in acquiring junior debt at a discount that would not necessarily attract much of the increase in value resulting from a reorganization, but then blocking this reorganization until the other creditors (especially those who hold fulcrum securities because they have the most to gain from the reorganization) and equity holders (to the extent that they proposed or are backing a plan that does not totally dilute them) accept to "buy" the consent of the distressed debt investor to the plan, by allowing the investor to swap its debt for a greater share of the post-reorganization debt or equity than it would normally deserve or obtain some extra.

This strategy was implemented for instance by the "vulture funds" Oaktree Capital Management and Franklin Mutual Advisers, which together owned almost half of Eurotunnel's pounds 1.9bn. lower ranking Tier 3 debt – it is thought they managed to obtain each EUR 15m in underwriting fees in exchange for a write-off of their debt[40].

It was also implemented by Black Diamond in extracting 5% increased interest for senior debt it owned in Eurodisney in exchange for an extension.[41]

Although French insolvency law introduced in 2005, in addition to the general assembly of bondholders, creditors' committees who can force partial write-offs on their members (the vote is taken at a majority corresponding to at least 2/3rds of the amount of the claims of the creditors who took part to the vote, unaffected senior creditors not voting), and another law in 2009 (after the shortcomings of the Eurotunnel case[42]) specified that a plan could provide for a different treatment among creditors if circumstances justified, and subordination agreements taken into account, there remains a number of loopholes available to distressed debt investors wishing to pursue this strategy:

(i) some creditors, such as those secured by a fiducie and those holding trade claims of less important suppliers, need not integrate a committee hence can effectively refuse any debt writeoff;

(ii) there are only two committees, one regrouping the financial institutions and the other the main suppliers, and by providing that senior creditors who are not affected and will be paid in cash do not vote, the law suggests a contrario that the most junior creditors who would be crammed down in the U.S. can still vote hence oblige the holders of the fulcrum securities and shareholders to share with them;

[40] A. Osborne, supra note 17.
[41] Investir.fr, supra note 9.
[42] C. Bogie, supra note 15.

(iii) the law does not specifically provide that creditors' committees can vote write-offs that apply to their members against their will (it was even originally thought that they could only impose uniform grace periods, not write-offs) so courts may be hesitant to accept a plan of reorganization that proposes to cram down hence give nothing to the most junior creditors.

The fact that the insolvency rules of France and other European countries do not permit the implementation of a cram-down plan of reorganization as easily in the U.S., hence make European companies more vulnerable to "pay-me-or-I-will-be-unreasonable" strategies (such as those experienced by Eurotunnel and more particularly French companies who attempted to deleverage their capital structure before investors' committees were created in French safeguard and judicial reorgainzation proceedings in December 2005), may explain why the management of Lyondell decided to place only its U.S. subsidiaries into bankruptcy and not its European subsidiaries.

(c) Extending an existing loan or making a debtor-in-possession loan

An active investment strategy facilitating or blocking the reorganization of the debtor's business can be combined with, in order to give time for the debtor to reorganize its business, an "amend and extend / forward start facility" strategy, which consists in agreeing to extend the term of an existing loan or refinance it for a significant arrangement commission and a greater interest rate.

Because this operation may be cancelled in France if the debtor is found to have been in "cessation of payment" at the relevant time, in case of doubt, it should be done while the company is directed by an ad hoc administrator (see Legal Schedule) or undergoing conciliation proceedings.

Once a debtor has been placed under insolvency proceedings, it is obviously still possible for it to receive a new loan, which is called in the U.S. a debtor-in-possession (or "DIP") loan by reference to the fact that the management has not relinquished control over the indebted company. The ranking of such loan and whether it can be used as a forward start facility (to rolleover existing debt) however vary from one jurisdiction to the other, and in France according to the type of proceedings.

We compare hereafter the use of DIP loans (i) in the U.S. and (ii) in France.

(i) In the U.S.

In the U.S.[43], although the legislative intent of Congress was to attach a first-ranking lien in favour of post-petition debt (i.e., debt incurred after the commencement of insolvency proceedings) only as a last resort, DIP loan markets are generally inefficient so that there is little competition among lenders for granting DIP loans, forcing debtors to request the bankruptcy court to approve DIP loans with both:

(A) important arrangement fees for the lenders; and

(B) first-ranking liens on the debtors' assets.

A bankruptcy court will accede to such request provided that any other creditors who had a security interest in the relevant assets is "adequately protected" (in light of the "equity cushion" corresponding to the difference between the value of the relevant collateral and the amount of debt secured by the security interest encumbering it), and subject to local rules adopted by some bankruptcy courts placing restrictions on DIP loans.

[43] H. Nesvold, J. Anapolsky, A. Lajoux, supra note 37 at pp. 425-435.

In the U.S., a distressed investor who has concerns about the valuation of the distressed debt's collateral or the perfection of the lien over such collateral, can therefore strengthen its position by participating in DIP loan consisting of fresh capital plus the roll over of pre-petition debt (i.e., debt incurred prior to the commencement of insolvency proceedings) into post-petition debt. Although in theory a DIP loan could prime senior debt, in practice senior debtors would either object that they are not adequately protected (a so-called priming fight) or just participate in any rollover DIP loan.

(ii) In France

A similar strategy can be implemented in France through (A) a new-money loan granted during a (pre-insolvency) conciliation proceeding or, but with greater constraints, (B) during safeguard or judicial reorganization proceedings (see part 1 of the Legal Schedule for a summary of the various French pre-insolvency and insolvency proceedings).

(A) During conciliation proceedings

A new-money loan can be granted during a conciliation proceeding in order to roll over (refinance) at least short-term debt.

We have seen new-money loans for terms in excess of 5 years having been approved by courts (whereas, in the U.S., the maturity of a DIP loan is usually the earlier of the consummation of the plan of reorganization and the target time frame for completing the bankruptcy case).

One must also be aware that although the lien protecting a loan granted during conciliation proceedings ranks higher than security interests encumbering most types of collateral, it does not attach to certain assets such as security-assigned receivables, pledged cash, pledged bank accounts, all personal property that is saddled with a true right of retention, and all other pledged personal property in case of the opening of a judicial liquidation proceeding (to the extent that pledgors may claim their judicial attribution hence bypass all other creditors).

(B) During safeguard or judicial reorganization proceedings

In a safeguard or judicial reorganization proceeding, however, although post-petition creditors will also have a preferred claim (albeit ranking below the claim of conciliation new-money lenders; see part 2 of the Legal Schedule for further details on ranking), it is not possible to roll over pre-petition debt because its payment is forbidden.

3.3 <u>Active investment strategies aiming control</u>

These strategies aim at not only taking an active part in the reorganization of the company but actually taking control of it (and replace management) or acquiring its business or key real assets.

Altman and Hotchkiss[44] report that this strategy, in the U.S., typically involves an exit within 2 to 3 years and a target return of 20% to 25% p.a.

[44] E. Altman and E. Hotchkiss, supra note 1, at p. 189.

This long time period can be explained by the time it takes for, after having taking control of a business, installing the right systems and controls and implementing the necessary strategies for maximising ROIC (until them saddled with agency costs), before reselling the business.

We discuss hereafter strategies involving (a) the conversion of debt into a controlling interest in equity and (b) the acquisition of a business or real asset of the company.

(a) Acquiring enough debt to have it converted into a controlling interest in the equity of the debtor ("loan to own")

In France, like in the U.S., the debtor must agree to a plan involving the issuance of equity paid up with existing debt, it being noted that this equity would have no or little value unless the capital structure is sufficiently deleveraged.

Investors wanting post-organization equity will buy the fulcrum debt, which is the more likely to be converted into equity or (like in Eurotunnel) convertible bonds, it being noted that the most senior debt is typically repaid in cash (investors wanting post-organization equity would therefore more likely invest in senior debt)[45].

Investors wishing a controlling position in a company are also advised to verify if another distressed debt investor pursuing such an aim has not already started accumulating positions in the same company.[46]

(b) Acquiring a business or real asset

The situation differs (i) in the U.S. and (ii) in France.

(i) In the U.S.

In the U.S.[47], a distressed debt investor can cause the debtor's assets (specific assets or the debtor's business) to be sold to it under a so-called 363 sale (in chapter 11 proceedings) or as part of a chapter 7 liquidation process, to the distressed investor (an "asset swap").

Recent 363 sales in the U.S. include the sale of Lehman Brothers to Barclays Capital in 2008, and the sale in July 2009 of a number of GM's assets to a new company owned by the U.S treasury and other creditors.

In that situation, a distressed debt investor acquire the assets of a company at a discount (compared to their market value) by:

(A) securing the position of "stalking horse" during DIP loan negotiation, which designates the potential purchaser who is the first to bid for the debtor's assets (hence establishing a minimum valuation used by the auctioneers in marketing the assets), after having had the benefit of conducting due diligence review (the cost of which can be recouped through breakup fees between 1% to 5% of the purchase price in case of an overbid): other potential buyers probably will not be able or willing (without a breakup fee) to perform as deed a due diligence review, hence will likely more prudently appraise the asset's value than the stalking horse;

(B) "credit bidding", which consists in offering cash only for the portion of the price that will be allocated to more senior lenders and the distressed investor's own debt for the remaining portion up

[45] S. Moyer, supra note 27, at p. 240.
[46] S. Moyer, supra note 27, at p. 241.
[47] H. Nesvold, J. Anapolsky, A. Lajoux, supra note 37 at pp. 373-402.

to the face value of that debt (to the extent permitted by applicable case law, the 3rd Circuit Court of Appeal having prohibited credit bidding for a 363 sale that was part of a plan of reorganization): other potential buyers will be afraid of overbidding a credit bidder who, for all they know, might be playing a game with them by bidding more than his estimation of the market value of the assets (but within the limit of the aggregate amount of the face value its fulcrum securities and any senior debt) in the hope that some other purchaser will mistakenly overestimate the market value of the assets, it being noted that the seniority waterfall of the debts will cause any excess price to benefit the distressed investor as holder of the fulcrum securities.

(ii) In France

In France, the following considerations must be taken into account before a distressed debt investor buys the business or a key real asset.

(A) Timing

Unless he asked to be appointed as "controller", a distressed debt investor may bid for the acquisition of individual assets, a division or the whole business of the company in a sale organized either:

1) outside court proceedings, but this operation may be cancelled if the debtor is found to have been in "cessation of payment" at the relevant time (in case of doubt, it should be done while the company is directed by an ad hoc administrator or undergoing conciliation proceedings (see Legal Schedule));

2) regarding sales of individual assets: during the observation period, as part of a safeguard or reorganization plan, or as part of a liquidation proceeding;

3) regarding sales of divisions: at the end of the observation period of a safeguard proceeding or of a judicial reorganization proceeding, or as part of a liquidation proceeding;

4) regarding sales of the whole business: at the end of the observation period of a judicial reorganization proceeding, or as part of a liquidation proceeding.

(B) Stalking horse strategy – not really

Although the process in France does not involve the negotiation of an asset purchase agreement with a "stalking horse" who obtains breakup fees if he is outbid, it is possible for individual asset sales in the context of liquidation proceedings to ask for permission for a private (i.e., non-auction) sale. Other sales are all conducted through an auction process.

(C) Credit bidding – must show the money

Although a distressed investor cannot offer to pay part of the purchase price as setoff with its own claim (credit bidding), nothing prevents him from offering a price he considers to be in excess of the market value of the assets. Relying on his fulcrum position in the waterfall of preferred creditors regarding the relevant assets (in case of the sale of a division or the whole business, the court will breakdown the total price per category of assets, it being noted however that it is customary for inventory to be priced separately), the distressed investor can then forecast to obtain the restitution of the excess price through repayment of its fulcrum debt (albeit after consignment of the proceeds until the end of the proceedings, when the claims of everyone have been defined and approved).

A distressed creditor should however be aware of the adverse tax consequences of overstating a price, as discussed in the Legal Schedule.

(D) Consideration for the workforce

As regards sale of entire divisions or the entire business, one must however be aware that the court will not only look at the amount of the price offered (and whether there is a bank guaranteeing the payment of the price at completion) but also if it presents the best conditions for the workforce attached to the division.

(E) Tax disadvantages of asset deals

One must finally be aware that asset deals are often less advantageous than share deals from a tax point of view, in considering whether taking control through the purchase of the business or the taking control of the company. The advantages and disadvantages of share deals over asset deals are discussed in part 4 of the Legal Schedule.

4 VALUATION OF A FRENCH DISTRESSED DEBT

A debt owed by a French company in distress should be valued by (3.1) identifying the different scenarios (and sub-scenarios) that may occur, (3.2) allocating a probability for each one occurring, (3.3) assessing the cash flows associated with each scenario, (3.4) determining the distressed debt investor’s discounting rate, and feeding this data into (3.4) a discounting cash flow (“DCF”) analysis.

4.1 Identifying the possible scenarios

The main possible scenarios are the following, as illustrated in figure 6 below:

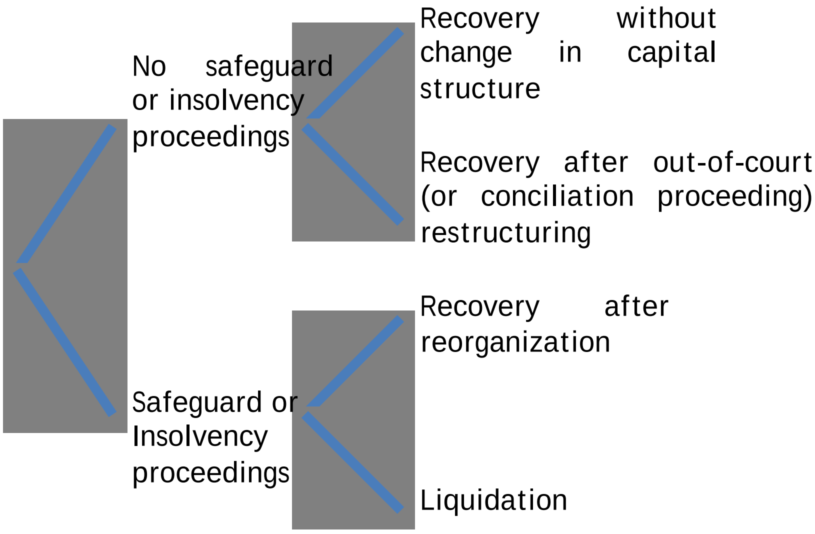
(a) the company recovers without change in its capital structure;

(b) the company undergoes an out-of-court restructuring, typically through confidential conciliation proceedings, and recovers;

(c) the company undergoes a safeguard proceeding or judicial reorganization proceeding and recovers;

(d) the company undergoes a liquidation proceeding.

Figure 6. Tree of scenarios



Of course, the above tree should be adapted where other specific scenarios are contemplated such as the sale of a division or key real asset to a third party or to the distressed debt investor itself. Other scenarios are the debtor using its available cash to buy back the distressed debt and the investor granting a DIP loan and cashing important arrangement fees.

4.2 <u>Determining the probability of each scenario</u>

In order to assign a probability to each scenario, we must (a) identify the causes of the distress and, if these causes are remediable, (a) weigh factors increasing the probability of a successful out-of-court restructuring or reorganization.

(a) Causes of distress

The distress may be caused by:

(i) the company's industry having ceased to be attractive (e.g., commoditisation of products) or the company's loosing its competitive advantage in its industry, because its products and services attract a lower willingness to pay from customers and/or its costs have increased, as evidenced by negative operating cash flows: in case of such a failing business model (and unless the distressed debt investor wants to take control and remedy the situation by changing the business model, which may involve changing industry), the probability of the liquidation should be assessed very high (which does not mean by itself that buying debt in such a company is not a good investment, as the value of the company's assets in case of an orderly sale during liquidation proceedings may be substantial or, even if not, because the investor intends to buy only the fully-secured most senior low-coupon debt the acceleration of which will actually increased the present value of its repayment cash flows);

(ii) the macroeconomic context, especially if the company is in a cyclical industry: the company could recover by itself without any restructuring as the economy recovers;

(iii) poor management, in which case the business is more likely to recover after a reorganization involving the change of management or the sale of the business;

(iv) capital structure problem, which may result from a too optimistic business plan (like Eurotunnel); in that case, as more developed below, the likelihood of a successful out-of-court restructuring or reorganization involving deleveraging can be significant.

(b) Factors increasing the likelihood of a successful out-of-court restructuring or reorganization

The factors increasing the likelihood of a successful out-of-court restructuring or reorganization, where the capital structure is deleveraged so as to reduce the financial distress costs (a competitive cost of debt compared to other firms in the same industry, customers and suppliers willing to trade on normal business terms) are[48]:

(i) the importance of the firm's excess liquidity – or potential excess liquidity through the disposal of more or less liquid assets including divisions – which could be used by the debtor for deleveraging by buying back debt at discount,

(ii) the absence of secured debt with elaborate financial covenants resulting in the debtor being forced to allocate proceeds of disposal of fixed assets and even all or a significant portion of other free cash flows to the repayment of this secured debt, effectively preventing the borrower from deleveraging by buying back more junior debt at discount;

(iii) the time remaining until the firm's next significant liquidity event (the next interest payment or capital repayment that will not be honoured if the company does not reorganize in the meantime) is long enough for reorganizing the debtor.

Should also be factored the possibility to terminate uneconomical long-term contracts through safeguard or judicial reorganization proceedings and, in case of a strategy aiming for control, the likelihood of gathering enough control to reduce agency costs.

4.3 Determining the cash flows associated with each scenario

It is tempting to use the Euro (or other currency) value of the LGD given the amount of the debt (the exposure at default), "€LGD", for determining the recovery of a particular distressed debt to its investor, because of the simplicity of this concept.

We prefer however to look at the timing and amount of the cash flows an investor can expect from a distressed debt, be it in interest payments and capital repayments in case the debt is maintained (albeit extended and possibly partially discharged) or swapped for another debt (which is more likely the case of senior debt), or in prepayment in case of liquidation.

Furthermore, if the debt is to be swapped for equity (which is more likely the case for fulcrum debt), then the value of the resulting equity should be assessed using the adjusted present value method (more adapted to a changing capital structure because of a changing WACC), as indicated below, and deducting the value of debt (and of any preferred stocks if the investor is granted common stock) then multiplying the result by the percentage corresponding to the investor's share of the common stock.

And if the debt is junior debt that with a LGD of 100% in case of liquidation or even sale of the business, but that cannot be written off without the holder's consent in a reorganization proceeding (e.g., trade debt of ancillary suppliers who need not participate to the main suppliers' creditor committee, debt against small companies for which

[48] S. Moyer, supra note 27 at pp. 238-242.

creditors' committees are not set up), the cash flow corresponds to the money the creditor could extract from the other stakeholders for consenting to the writeoff of this debt as part of a plan (with reference to the face value of that debt and the increase in value for other stakeholders – especially fulcrum creditors and equity holders - expected from the plan).

In the remainder of this section, we examine more particularly the valuation of fulcrum debt in case of a successful out-of-court restructuring or reorganization with reference to (a) the increased enterprise value that can be expected form such successful out-of-court restructuring or reorganization and (b) the portion of that value that can be allocated to the fulcrum debt holder.

(a) Assessing the increased enterprise value

An increased enterprise value may result from reduced financial distress costs adversely affecting the company's return on invested capital (fleeing clients diminishing revenues, suppliers who want to be paid cash increasing working capital requirement), its weighted average cost of capital (high interest on debt), and invested capital (company forced to sell its assets or business(es) at their liquidation value or below in case of a fire sale). An increased enterprise value may also result from reduced agency costs after replacing management.

The enterprise value should be assessed using the adjusted present value method (more adapted to a changing capital structure because of a changing WACC), by:

(i) calculating the present value of the free cash flows expected in certain number of years, which should reflect a certain growth in the first years as financial distress costs and possibly agency costs are reduced, discounted at the unlevered cost of capital "r_A" (assuming an all-equity capital structure);

(ii) adding the present value of the interest tax shield corresponding to the same period corresponding to the tax rebates from interest payments (t_C x D x r_D) for each profitable tax year after existing carried forward tax losses have been used up, discounted at before-tax cost of debt (r_D) ;

(iii) adding the continuing value at the end of that period (usual company valuation techniques such as the value driver formula can be used, the EBITDA multiple technique being quite popular amongst investors[49]) to determine firm value.

(iv) adding the value of non-operating assets (if any!) to determine enterprise value.

It is underscored that the method consists in calculating increased enterprise value by forecasting free cash flows assuming no financial distress costs and (in case of a strategy aiming control) no agency costs.

(b) Assessing the portion of the value so created going to the fulcrum debt

Any increase in enterprise value should normally (in case of sale of the business or in case of application of the absolute priority rule in a reorganization) go to the fulcrum debt.

Distressed debt investors considering to buy fulcrum debt that is unsecured should however be wary of the possibility of the debtor increasing its senior indebtedness subsequently, resulting in the fulcrum position moving from this unsecured debt to

[49] Revenues multiples are also popular when an investor considers that EBITDA potential is underestimated by the mediocrity of current management. Depending on the business model, asset-based valuations and customer-based valuations can also be useful.

more senior debt. More particularly, an investor should check if the debt instruments contains:

(i) any negative pledge covenant limiting the debtor's ability to pledge the remaining assets that were not pledged already – or grant second-ranking liens on assets already pledged but not for debt of a lesser value – in favour of existing or new secured lenders or

(ii) any covenant that would prevent the debtor from increasing its debt toward senior lenders to match the value of the collateral of that senior debt.

4.4 Determining the distressed debt investor's discounting rate

A distressed debt investor will also have to determine the appropriate discount rate it should use for valuing an investment (it being noted that a different discount rate may be used in different scenarios).

According to Moyer's book written in 2005, because of the relatively high risk associated with investing in distressed debt, most investors tend to require returns of between 15% and 25%[50]. Altman and Hotchkiss[51] add that target returns vary according to the strategy followed: 12% to 20% p.a. for passive investors, 20% to 25% p.a. for active investors not aiming for control, and 20% to 25% p.a. for active investors aiming for control.

These figures are in line with the median returns obtained by distressed private equity investors between 1999 and 2008 presented in the introduction of this paper, setting the benchmark for investors.

More specifically, the appropriate discount rate should depend on the expected return of the particular distressed debt investment using (a) the capital asset pricing model or, better, (b) the liquidity-adjusted capital asset pricing model.

(a) Using the capital asset pricing model

According to the capital asset pricing model, the expected return of distressed debt investment can be calculated according to the following formula:

$E(r_{DD}) = r_F + ß_{DD}(r_M - r_F)$

where

(i) "r_F" is the risk-free rate of return for a term similar to that of the contemplated distressed debt investment, which can be determined by reference to the relevant country's treasury bonds or bills for the same duration;

(ii) "$(r_M - r_F)$" is the market premium, which is around 5% but varies between 4.2% and 6.0%[52];

(iii) "$ß_{DD}$" is the distressed debt's return beta, which is:

(A) in the case of an investment in the most senior debt which is not the fulcrum debt and where there is a cushion between the amount of this senior debt and the enterprise value: in our view, $ß_{DD}$ should be close to zero and in fact this debt could be valued as other debt instruments but assuming repayment on the date expected in the relevant scenario;

[50] S. Moyer, supra note 27 at p. 104.
[51] E. Altman and E. Hotchkiss, supra note 1, at p. 189.
[52] Professor Massimo Massa's INSEAD Advanced Corporate Finance Course materials.

(B) in the case of an investment in fulcrum debt that is the most senior debt (and ignoring for simplification purposes the quantification of the absence of upside beyond a certain level with fulcrum debt): the business' return beta "$ß_A$", corresponding to the covariance between the returns of the business of the debtor and the returns of all assets (using stock market as proxy), divided by the variance of the returns of all assets (again using stock market as proxy)) – this figure may be obtained by looking at the (delevered) beta of competitors in the same industry;

(C) in the case of an investment in fulcrum debt that is not the most senior debt, given the financial risk associated with the most senior debt (and ignoring for simplification purposes the quantification of the absence of upside beyond a certain level with fulcrum debt):

$$ß_{DD} = ß_A[1+(1-t_C)\ D_S/D^*]$$

or, if the cost of senior debt is readily available, according to the improved version of Hamada's equation suggested by R.D. Cohen substituting D_S by the present value of the interest payments on senior debt discounted at the risk-free rate of return ($D_S \cdot k_{ds}/r_F$)[53]:

$$ß_{DD} = ß_A[1+(1-t_C)\ (D_S \cdot k_{ds}/r_F)/D^*]$$

where:

1) "$ß_A$", the business' return beta, has the meaning ascdribed to it above;

2) "t_c" is the effective marginal tax rate, which will generally be zero during the time the investors holds the investment;

3) "D_S" is the market value of the debt that is senior to the distressed debt being acquired (hence should have the same value pre and post-reorganization);

4) "k_{DS}" is the cost of the debt that is senior to the distressed debt being acquired;

5) "$D_{F"}$ corresponds to the theoretical value of the debt being acquired, namely the difference between the company's enterprise value (at the end of the relevant scenario) and D_S.

(D) in the case of an investment in junior debt that would have no value in case of sale of the business or a reorganization applying the absolute priority rule, but which a distressed debt investor might be willing to extract some value from by using it to block a reorganization: in our view, $ß_{DD}$ should be zero because, even if enterprise values go down across the board, there will always be a fulcrum class that will be willing to pay for the consent of a junior debt holder - the risk of the business being sold rather than reorganized would normally have been already taken into account in determining the probability of each scenario, it being noted that our model ignores any of systemic variations of the increase in enterprise value to be expected from the reorganization (which will influence the price other stakeholders are willing to pay for the junior creditor's consent).

[53] R.D. Cohen, supra note 31.

It follows that the riskiness of a distressed debt investment will vary from an investment to another and (for fulcrum debt) depending on the business risk reflected in the asset beta of the business invested in and (if the fulcrum debt is not the most senior debt) the added financial risk that can be estimated using Harmada's equation (or its improved version referred to above).

Given the important mathematical impact of financial risk, one should be especially careful when investing in fulcrum debt of a class representing a small percentage of the enterprise value, not to reproduce in the distressed debt market the anomaly seen in the distressed equity (which is risk-adjusted underperforming, the market seeming to ignore the additional financial risk[54]).

Unfortunately, it appears that a number of hedge funds advertise distressed debt investment as total return investments and their incentive fees are based on a hurdle rate that is not risk-adjusted, so that we doubt that elaborate risk calculations as the above are actually performed by many actors on the distressed debt market.

(b) Using the liquidity-adjusted capital asset pricing model

According to liquidity-adjusted capital asset pricing model developed by Acharya and Pedersen[55], the expected return of a fulcrum distressed debt investment like the ones described in (a) above (whereas senior debt which is not the fulcrum debt may be calculated as a debt instrument looking a going yields factoring an illiquidity premium) should be calculated according to the following formula:

$E(r_{DD}) = r_F + E(c_{DD}) + (ß_1 + [ß_2 - ß_3 - ß_4]) (E(r_M - c_M - r_F))$

where

(i) "$E(c_{DD})$" is the expected relative illiquidity cost, corresponding to the difference between the true value of an investment (using the original capital asset pricing model) and the price one could resell it (at the end of the relevant scenario), expressed as a percentage;

(ii) "$ß_1$" corresponds to the covariance between the expected returns of the investment and the returns of all assets (using stock market as proxy) (cov (r_{DD}, r_M)), divided by the variance of the returns minus the relative illiquidity cost of all assets (again using stock market as proxy) (var (r_M- c_M)), quantifying the desire of investors to be compensated for holding a security that produces less returns when the market in general produces less returns (the premise behind the capital asset pricing model);

"$[ß_2 - ß_3 - ß_4]$" is the net liquidity beta measuring "liquidity risk" (contributing in average for 1.1% to the difference in risk premium between NYSE/AMEX-listed stocks with high expected illiquidity and low expected illiquidity[56]), where:

(A) "$ß_2$" corresponds to the covariance between the expected liquidity of the investment and the liquidity of all assets (cov (c_{DD}, c_M)), divided also by var (r_M- c_M), quantifying the desire of investors to be compensated for holding a security that

[54] R. McEnally and R. Todd, "Systematic risk behavior of financially distressed firms", Quarterly Journal of Business and Economics, 22 June 1993. J. Campbell, J. Hilscher, and J. Szilagyi, "In Search of Distress Risk", The Journal of Finance, vol. LXIII, No. 6, December 2008 at p. 2899.

[55] Acharya, V.V. and Pedersen, L.H. (2005) Asset pricing with liquidity risk. Journal of Financial Economics 77: 375–410. See also X. Hua and Z. Jian, "Pricing liquidity risk and cost in the stock market: How different was the •nancial crisis?", Journal of Asset Management, 1 June 2011.

[56] Ibid., at p. 377.

becomes illiquid when the market in general becomes illiquid (contributing in average for 0.8% to the difference in risk premium between NYSE/AMEX-listed stocks with high expected illiquidity and low expected illiquidity[57]);

(B) "$ß_3$" corresponds to the covariance between the expected returns of the investment and the liquidity of all assets (cov (r_{DD}, c_M)), divided also by var (r_M- c_M), quantifying the desire of investors to accept a lower return on an asset with a high return in times of market illiquidity (contributing in average for 0.16% to the difference in risk premium between NYSE/AMEX-listed stocks with high expected illiquidity and low expected illiquidity[58]);

(C) "$ß_4$" corresponds to the covariance between the expected liquity of the investment and the returns of all assets (cov (c_{DD}, r_M)), divided also by var (r_M- c_M), quantifying the desire of investors to accept a lower expected return on a security that is liquid in a down market (contributing in average for 0.82% to the difference in risk premium between NYSE/AMEX-listed stocks with high expected illiquidity and low expected illiquidity[59]);

(iii) "c_M" is the market's illiquidity premium, which Acharya and Pedersen estimate at 3.5% based on NYSE and AMEX stock returns between 1962 and 1999[60];

(iv) the other letters have the meaning ascribed to them above.

It goes beyond the scope of this project paper to explore in greater detail the application of this novel formula to distressed debt investments, for which en passant data is not as readily available as for NYSE and AMEX stocks (for which Acharya and Pedersen estimated the combined effect of the differences in liquidity risks (1.1%) and differences in the level of liquidity (3.5%) to be 4.6% per year[61]).

It may however be noted, as a rule of thumb, that the longer the term of the payoff according to the relevant scenario, the greater the expected return should be because of the illiquidity of the investment in the mean time.

Indeed, the greater target returns attributed by Altman and Hotchkiss[62] to active investment strategies aiming control (20% to 25% p.a. for a 2 to 3-year holding period) compared to active investment strategies not aiming control (15% to 20% p.a. for a 1 to 2-year holding period) and passive investment strategies (12% to 20% p.a. for a 6 to 12-month holding period) can be explained by the illiquidity of the investment while the strategy is implemented[63].

[57] Ibid., at p. 377.
[58] Ibid., at p. 377.
[59] Ibid., at p. 377.
[60] Ibid., at p. 377.
[61] Ibid., at p. 377.
[62] E. Altman and E. Hotchkiss, supra note 1, at p. 189.
[63] Although the fact that "loan to own" strategies aiming for control target fulcrum securities, which we have seen are likely to have a higher financial risk, may also contribute to the higher target returns of strategies aiming for control.

4.5 DCF analysis

We examine below the four steps of a DCF analysis that could be performed by an investor expecting either a successful out-of-court restructuring or reorganization or sale of the whole business as a going concern to a third party, a liquidation, or another outcome:

(a) assuming a successful out-of-court restructuring or reorganization, or sale of the whole business as a going concern to a third party:

(i) calculate the present value as at this event of the future cash flows of the assets of the company at their going concern value as from this event, using the adjusted present value method as indicated above;

(ii) subtract the value by then of the debt that is senior to the distressed debt that the distressed investor wants to acquire;

(iii) discount using the applicable discount rate to find the present value of these contingent cash flows;

(b) assuming a liquidation and sale of the individual assets of the company at their orderly sale value:

(i) identify (if any!) those cash flows generated by the disposal of the individual assets that will be allocated to the distressed investor, after payment of all debt senior to the distressed debt;

(ii) discount each cash flow at the relevant discount rate;

(c) if any other outcome is possible, such as a situation where one or more divisions would be sold as a going concern and the remainder of the assets of the company would be sold at their foreclosure value in a liquidation, calculate the present value of these various cash flows for the distressed investor following the principles outlined above;

(d) calculate the weighted average of the present values calculated in A, B, and C, the weight allocated to each of them being proportional to the probability of each event occurring.

CONCLUSION

As in the U.S., the fundamental sources of value creation for distressed investors in France are the possibilities:

- to buy low because of excess supply (forced sellers), limited demand (asymmetry of information), and an illiquidity discount (high transaction costs and investors forced to overweigh the distressed debt in their portfolio), including to buy at par senior debt that should trade a premium because of its potential acceleration;
- without the investor's active role, to resell high once the above causes of downward pressure on debt prices (or upward pressure on the prise of most senior debt anticipating an acceleration with a LGD close to 0%) have diminished in intensity, and possibly to add value by collecting slices of debt from various creditors and reselling them in bulk to the borrower or an affiliate thereof;
- to take an active role in the reorganization without aiming control and benefitting directly (as holder of the fulcrum securities) or indirectly (by "selling its consent") from the increase in enterprise value resulting from lesser financial distress costs (lesser WACC after deleveraging the capital structure, increased ROIC as customers and suppliers accept to extend credit to the company, maintained invested capital as capex programmes are maintained and key real assets are not sold);

- to take an active role in the reorganization and aiming for control, benefitting from the from the increase in enterprise value resulting from lesser agency costs but without necessarily paying a control premium upon acquiring the distressed debt.

It is true that, compared to the U.S., France:

- has more constraints when it comes to acquiring distressed debt at a discount and valuing French distressed debt can be quite complicate because of the complexity of the insolvency rules hence the various scenarios, especially when a cram-down plan of reorganization is contemplated,
- does not easily permit lenders to roll-over pre-petition debt (except in case of conciliation proceedings),
- does not offer the possibility for distressed investors to take on a "stalking horse" position and do credit bidding, and in case of sale of an entire division there is a risk that the winning bid may not be the one that offered the best price but the one that preserved employees the most, and
- allows junior creditors to exercise a power of nuisance on the restructuring process to the extent that French creditors' committees cannot "cram down" all junior debts.

Yet these constraints and the segmentation of the European market into national markets (because of national insolvency laws) translate into a lesser number of distressed debt investors active in the French market than in the U.S., those who decide to invest in France facing less competition hence potentially being able to obtain greater discount when purchasing French distressed debt.

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SCHEDULE: SUMMARY OF APPLICABLE FRENCH RULES

1 FRENCH PRE-INSOLVENCY AND INSOLVENCY RULES

After summarising (1.1) rules restricting out-of-court restructurings, we shall summarily describe (1.2) the role of the ad hoc administrator, (1.3) conciliation proceedings, (1.4) safeguard and judicial reorganization proceedings, and (1.5) judicial liquidation proceedings.

1.1 Rules restricting out-of court restructurings

When attempting to carry out an out-of-court restructuring, one should be aware of the French equivalent to the U.S. rules regarding fraudulent conveyances as regards (a) security interests granted by and transactions with a company in "cessation of payment" and (b) upstreaming and cross streaming, as well as (c) rules regarding grace periods.

(a) Void security interests and transactions entered into with a company in "cessation of payments"

Any transaction with a debtor may be declared void if it is entered into during the "suspect period", namely the period between the date of cessation of payment of the settler and the date a judicial reorganization (redressement judiciaire) or judicial liquidation (liquidation judiciaire) proceeding is commenced against said debtor, it being noted that a court whose judgment opens such proceeding can declare the debtor to have been in a state of cessation of payment up to 18 months before the judgment date.

New security interests granted as security of existing debt will be declared void during the suspect period[64]. New security interests granted as security of concomitantly-created debt, and more generally any transaction with the debtor during the suspect period even if entered into on fair terms, can be avoided by the court if the other party knew of the state of cessation of payment of the settler.

This contrasts with the test for fraudulent conveyances in the U.S., which requires either:

(i) actual intent to hinder, delay, or defraud creditors, or

(ii) the combination of

(A) "less than reasonably equivalent value" and

(B) that the company either

1) be insolvent at time of transfer,

2) be left with unreasonably small capital as a result of transfer, or

3) incurred or intended to incur debts beyond its ability to pay.

(b) Upstreaming and cross streaming

Upstreaming consists in a subsidiary granting a loan to, or collateral as security for the debt owed by, a parent company. Cross-streaming is like upstreaming but in respect of a sister subsidiary.

Compared to most legal systems in the world, French law is very restrictive when it comes to upstreaming and cross-streaming. This is relevant for all parties given that

[64] Article L.632-1 of the Commercial Code.

not only the subsidiary's management can be convicted for a criminal offence, but also lenders who knew of the lack of corporate interest of the subsidiary can loose their security interest.

In the U.S., although upstreaming or cross-streaming results in the subsidiary getting "less than reasonably equivalent value", there is no fraudulent conveyance if the transaction passes all three additional tests (solvent company, no unreasonably small capital, ability to pay). (It is another issue whether the directors who authorised upstreaming or cross-streaming can be sued for breach of their duty of loyalty or lack of good faith.)

In France, in contrast, such transactions may be avoided by the court whenever they are found to have been not in the best interests of the company, notwithstanding the company's solvency at the relevant time. Upstreaming or cross-streaming will be considered in the French company's best interest when limited to the outstanding indebtedness of the French company toward the relevant parent; it is unclear to what extent other settings would pass the best interest test before a court.

(c) Proportionality of the security package

The efficiency of a security interest could be challenged pursuant to article L.650-1 of the Commercial Code, which provides that, "When a safeguard, judicial reorganization, or judicial liquidation proceeding is opened, the creditors cannot be held liable for the damages suffered as a result of the facilities granted except in case of fraud, characterised immixing in the management of the debtor or if the security taken as consideration of these facilities is disproportionate thereto. When the liability of a creditor is upheld, the security taken in consideration of his facilities can be annulled or reduced by the judge." In the absence of French Supreme Court case law clarifying what makes a security "disproportionate" to a facility, it however is difficult to ascertain the implications of this provision.

(d) Grace periods

As a general rule, French courts have the power to grant payment grace periods to a debtor pursuant to articles 1244-1, 1244-2 and 1244-3 of the French Civil Code even if the latter is not insolvent, whether or not the relevant debt is governed by French law or a foreign law.

When a grace period is granted, the sum owed still bears interest but at a rate that can be reduced by the court down to the legal interest rate, and any increased interest or late payment fee can be declared non applicable during the relevant period. The court can also order the suspension of enforcement actions for the term of such grace period.

Before granting such grace periods, courts take into account the situation of the debtor and consider the needs of the creditor. Although in normal circumstances corporate borrowers cannot expect to benefit from grace periods, in theory they could argue that such remedy is necessary in order to facilitate an out-of-court restructuring process; in practice, this remedy is usually asked after the opening of a conciliation proceeding.

1.2 Appointment of an ad hoc administrator (mandataire ad hoc)

When a debtor is on the verge of insolvency, it is typical for its management to ask the court to appoint an ad hoc administrator with the roles of assisting the company and possibly approaching creditors with a mediation mission, it being noted that this appointment is confidential.

The role of the ad hoc administrator is somewhat akin to that of an insurer:

(a) management feel that their personal liability is better protected, as creditors would have a harder time proving acts of mismanagement or failure to timely report "cessation of payments" if management was assisted by an ad hoc administrator;

(b) creditors who agree to modify the terms of their debt are comforted that a court would not dare to cancel the transaction by finding the debtor to have been in a state of "cessation of payments" at the time it was assisted by an ad hoc administrator.

1.3 Conciliation proceedings

A conciliation proceeding can be commenced at the request of a debtor who demonstrates that he is encountering a "legal, economic or financial difficulty" and that, if he is in a state of "cessation of payment", he has not been in such a state for more than forty-five days. A conciliator (typically the same person as the one who assumed the role of ad hoc administrator) is then appointed for a maximum duration of four months, with possible extension for an additional month. Although such proceeding does not per se suspend the enforcement of security, a court will be more inclined to grant payment grace periods and suspend enforcement actions during such grace periods.

Most of the restructurings occur in the context of conciliation proceedings In France for the following reasons:

(a) debtors like it because:

(i) until the court ratifies the conciliation agreement at the end of the process, there is no public notice of a conciliation proceeding having been opened (suppliers and clients will not know about it), hence diminishing indirect financial distress costs;

(ii) they have more or less the assurance that the court will grant them payment grace periods accompanied with a stay of enforcement actions – some can even convince judges to grant them relief on contractual interest, a relief that does not exist in the insolvency proceedings examined below;

(iii) they can threaten minority creditors who refuse to participate in the restructuring to undergo an accelerated financial safeguard proceeding (see below);

(b) distressed investors also like it because:

(i) the success of the restructuring is also in their interests, so the three reasons above why debtors like conciliation proceedings also work for distressed investors;

(ii) the ratification by the judge of the conciliation agreement at the end of the process is viewed as a judicial certification of the legality of the security package of the DIP loan, more particularly there is no fear that the whole transaction will be avoided because entered into with a company in a state of "cessation of payment";

(iii) claims of creditors who inject new money during such conciliation proceedings are protected by the lien resulting from Article L611-11 of the Commercial Code, which ranks above claims of post-petition creditors and most secured claims should insolvency proceedings follow; this is the occasion for most lender to roll over at least the short-term portion of their existing loans.

1.4 Safeguard and judicial reorganization proceedings

Although both safeguard and judicial reorganization proceedings are "insolvency" proceedings within the meaning of the EC Regulation 1346/2000 on insolvency proceedings of 29 May 2000 and share similar rules, it should be noted as a preliminary comment that only the latter requires the debtor to be in a state of "cessation of payment" (i.e., where the debtor cannot establish that the stand-by credit or moratoriums granted to him by creditors allow him to pay his current liabilities out of his available assets).

(a) Safeguard (sauvegarde) proceedings

(i) Commencement

A safeguard proceeding can be commenced at the request of a debtor who demonstrates that he is not yet in a state of cessation of payment but that he is encountering difficulties that he cannot overcome, it being noted that property-owning companies can also apply for the protection of a safeguard proceeding as illustrated in the Coeur défense case of 8 March 2011.

The following people are then appointed by the court:

(A) one or more judge commissioners (juge-commissiare) for overlooking the development of the proceedings,

(B) a trustee (administrateur) for monitoring or assisting the debtor, at least where the debtor has at least 20 employees or EUR 3,000,000 of annual revenues,

(C) a creditors' representative (mandataire judiciaire) – who is not a creditor but a professional - in charge of collecting and verifying creditors' claims;

(D) possibly employees' representatives and controllers (including creditors).

According to article L. 622-29 of the Commercial Code, "The opening judgement does not render payable receivables that were not payable on the date it was rendered. Any clause to the contrary shall be deemed not to have been written". Hence it would not be possible to call a loan in default and ask for its repayment (and the application of late payment interest in case of non payment) on the sole ground that insolvency proceedings have been opened against a borrower (or that a borrower is in a state of cessation of payment leading to the opening of such a proceeding).

(ii) Observation period (période d'observation)

The opening of the procedure triggers a six-month period of observation, which may be renewed once (or exceptionally twice). During this observation period, no payments can be made (subject to the setoff of "connected" debts) and many security interests cannot be enforced (without prejudice to payment by setoff in respect of the sums recovered by enforcement of the security assignments[65], cash pledge, and bank account pledge). Also, contracts cannot be terminated on the ground of default of payment, creditors must declare their claims, and interest stops accruing except under loans greater than one year (under which interest continues to accrue at the contractual normal or default rate, and may be compounded in accordance with article 1154 of the Civil Code).

In practice, however, the observation period can last as long as is necessary (i) for the administrator to form any creditors' committees (30 days

[65] See below however on the possibility for the court to order the escrow of the sums payable by tenants under security-assigned receivables, and the use of a portion of these sums, corresponding to the service charges re-invoiced to the tenants, for the operation of the property.

normally), (ii) for the debtor to make its proposals (maximum 2 months extendable by another 2-month period), and (iii) for any creditors' committees and bondholders' general meeting (maximum 6 months as from the opening date) and the other creditors to consider these proposals, and (iv) once the consultation process is completed, for the trustee to have the court rule on the safeguard or reorganization plan, it being noted that courts refuse to sanction decisions made after the expiration of the maximum period.

During this observation period, a safeguard plan and possibly a transfer plan (for any or certain of the divisions of the debtor) may be prepared.

(iii) Safeguard plan (plan de sauvegarde)

(A) Approval

The court does not need creditor approval to adopt a safeguard plan providing uniform grace periods of up to 10 years (or 15 years in case of an agricultural business), with the first instalment payment intervening no later than one year and each annuity being equal to at least 5% of the total liabilities after the second year.

A creditor can be forced to accept a greater delay or a partial write-off of its claims only if he is part of a creditors' committee or bondholder general meeting whose majority approves the proposed plan, voting at a majority corresponding to at least 2/3rds of the amount of the claims of the creditors or bondholders who took part to the vote, unaffected senior creditors not voting. Thus, unlike in the U.S., senior creditors cannot push a cram-down that would comply with the U.S. absolute priority rule and best interests of creditors test.

Creditors' committees are formed only where the debtor has at least 150 employees or 20 million Euros of revenues (or with a special authorization from the judge commissioner). Two creditors' committees are then formed, whose composition and operations have been redefined by the French legislator after the Eurotunnel bankruptcy:

1) one regrouping the financial institutions[66], it being noted that their assigns (including distressed debt investors such as the investment fund that acquired Eurotunnel debt) have also the obligation to participate in this committee;

2) one regrouping the main suppliers (whose individual claims make up at least 3% of aggregate supplier claims – other suppliers have the right but not the obligation to participate).

The debtor has the initiative of presenting proposals to creditors' committees, who must rule on them within 20 and 30 days subject to postponement by the judge commissioner; creditors can also submit proposals but it is for the debtor with the concourse of the administrator to submit them to the creditors' committees.[67]

[66] Subject to certain exceptions, such as fiducie-secured creditors.

[67] In contrast, in the U.S., the exclusivity period (during which the debtor has the initiative of proposing a plan of reorganization) is of 120 days, it being noted that by filing a placeholder plan in the first 120 days the debtor may obtain 60 additional days (as solicitation period). Moreover, in the U.S., the exclusivity period is

A bondholders' general meeting is convened only if a plan has been approved by the two creditors' committees.

There are however no subdivision of these committees according to their members' ranking priority and no legal provision detailing how voted write-offs must be uniformly applied (it is courts who interpreted the new law as permitting uniform write-offs to be imposed by committees to all their members, but without going into the detail of whether uniformity should be considered only for the holders of the fulcrum securities, with senior creditors being fully paid and junior creditors receiving nothing).

The court retains the discretion to refuse to adopt a plan approved by all committees and the bondholders.

(B) Execution

Following its adoption, the execution of a safeguard plan is monitored by a commissioner (commissaire à l'exécution du plan), who may be the trustee or creditors' representative. In case of non payment of the sums owed under such a plan, only him may (and must) take recovery actions against the debtor after having become aware of the default.

The unpaid creditor may however ask the commercial court to terminate the plan, it being noted that:

1) if the debtor is not found to be in a state of cessation of payment, the court can (but is not compelled to) accede to the creditor's request; if it accedes to it, the creditor recovers the right to sue for payment the debtor and enforce its security interests;

2) if the debtor is found to be in a state of cessation of payment, the court must accede to the creditor's request, terminate the plan, and open judicial reorganization proceedings or, if reorganization is patently impossible (or if the plan was already a reorganization plan), open judicial liquidation proceeding.

(iv) Transfer plan (plan de cession)

The court may approve a plan for the transfer of any or certain of the company's division (in a safeguard proceeding, the plan cannot cover all divisions; it can in a reorganization proceeding).

The court has a degree of discretion in deciding a transfer plan or the keeping of the division within the debtor.

If a transfer plan is adopted, unlike in sales of individual assets (where the buyer who offers the highest bid wins), the court also has a degree of discretion in selecting the best offer for a division sold as a going concern, according to:

(A) the amount of the price offered,

(B) whether the payment of the price is guaranteed by a bank

routinely extended by court order (although the 120-day exclusively period cannot be extended beyond 18 months, and the 180-day overall period cannot be extended beyond 20 months).

guarantee,

(C) the intentions of the purchaser regarding the continuation of the activity and the employees, it being noted that it is not uncommon for purchasers to commit to retain key assets and employees for a number of years.

(b) Accelerated financial safeguard (sauvegarde financière accélérée) proceedings

An accelerated financial safeguard proceeding can be commenced at the request of a debtor undergoing a conciliation proceeding who cannot get his credit institution creditors to agree on a conciliation agreement and presents a plan that the court views as having the potential for being supported by a "large proportion" of them.

It then follows the same regime as a regular safeguard proceeding except that: it affects only creditors who are credit institutions and bondholders, the observation period is limited to one month (subject to a possible extension of an additional month), and a safeguard plan cannot be ordered by the court without the approval of the creditors' committee.

(c) Judicial reorganization (redressement judiciaire) proceedings

A judicial reorganization proceeding is opened at the request of a debtor in a state of cessation of payment or at the request of a creditor of a debtor who has been in a state of cessation of payment for over 45 days, it being noted that the court can unilaterally decide to open a judicial liquidation proceeding instead if it considers that reorganization appears impossible.

The judicial reorganization proceeding presents the same main characteristics as the safeguard proceeding (observation period of up to 18 months, reorganization plan of maximum ten years...). There are however some differences: the trustee has greater control over the affairs of the debtor, certain transactions that took place between the judgment date and the date of cessation of payment can be annulled (as seen in subsection 2.1), the reorganization plan can provide for the assignment of the entire business to a third party, the dismissal of employees is made easier.

1.5 Judicial liquidation (liquidation judiciaire) proceedings

A judicial liquidation proceeding is opened when the conditions for the opening of a judicial reorganization proceeding are met but reorganization appears impossible in the eye of the judge.

It is characterized by the appointment of a liquidator entrusted with the collection and verification of the creditors' claims as well as the sale of the assets. Sometimes a trustee is also appointed to continue temporarily the business (if necessary because a sale of the business or of certain divisions is contemplated or because some revenue-generating contracts must be performed).

Like in other insolvency proceedings, as from the judgment date, no payments can be made (subject to the setoff of "connected" debts) and creditors must declare their claims.

All the debts of the debtor become immediately payable and seizure and sale enforcement proceedings are still possible (provided that the liquidator does not take action within 3 months or after the expiration of the period for receiving offers if the asset is part of a division proposed to be sold as a going concern).

2 RANKING OF SECURITY INTERESTS IN FRANCE

The ranking of security interests over the assets of a French debtor will depend on the location of the collateral, the type of collateral, the type of security interest over that collateral, and the type of any ongoing insolvency proceedings.

Regarding the location of the collateral, Article 5 of EC Regulation 1346/2000 protects security interest over ("tangible or intangible, moveable or immoveable") collateral located in other member states of the European Union from the effects of French insolvency proceedings. This rule is relied upon in all major financings in France since the Coeur Défense of 8 March 2011 confirmed the easiness for a debtor to open safeguard proceedings (after the law was amended to reduce the conditions a debtor had to meet); today, all major financings rely on a "double luxco" structure where two Luxembourg are inserted as intermediate holding companies with one pledging its shares in the other, which pledge may arguably be enforced by lenders to take control of a French subsidiary that would have placed itself under safeguard proceedings and replace its management (although the risk of contestation for indirectly circumventing French public policy rules cannot be excluded).

Consequently the following developments will concern only collateral located in France and (subject to compliance with the perfection formalities applicable in both countries and the recognition by the foreign courts of the jurisdiction of French courts and the enforceability of French judgments) collateral located outside the European Union.

It is easier to present this topic according to the type of collateral that is encumbered by a security interest. Whereas (2.1) security interests over cash and receivable normally benefit to relevant secured creditors exclusively, the ranking of (2.2) mortgages over property and (2.3) security interests over inventories and other tangible personal property is much more complex.

2.1 Security interests over cash and receivables

Security interests over cash and receivable can normally be enforced in quite a straightforward and effective fashion, without any preference being given by law to an unsecured creditor even in case of French insolvency proceedings.

These include (a) cash pledges, (b) "Dailly-law" security assignments, and (c) bank account pledges.

(a) Cash pledges

Cash pledges can be enforced by appropriation of the cash collateral also notwithstanding the opening of insolvency proceedings

(b) "Dailly-law" security assignments

"Dailly-law" security assignments can be enforced by notifying the tenant or other debtor of the borrower that the relevant receivables are to be paid directly to the lender, notwithstanding the opening of insolvency proceedings. Please however note that the Cour de Cassation in the Coeur Défense case (16 November 2010) upheld the decision of the Court of Appeal of Paris to authorize the escrow of the sums corresponding to the assigned rents and the use of a portion thereof to pay the expenses necessary to the operation of the property given that the security assignment covered not only the rents but also the service charges re-invoiced to tenants and there was a risk that said money would "disappear" (i.e., as we understand it, not be allocated to said service charges).

(c) Bank account pledges

Bank account pledges can be enforced by notification to the account bank to pay the balance of the pledged account to the lender and, amidst different points of view by authors, recent case law of the Cour de cassation (26 May 2010) suggests that the pledgee would be able to bypass any preferred creditors in case of insolvency proceedings.

2.2 Mortgages over French property

In case of a safeguard or judicial reorganization proceeding opens, a mortgage cannot be enforced anymore – if the property is however sold to a third party, a mortgagees will have a right to the sale proceeds in the order set out below.

A mortgage can be enforced during a judicial liquidation proceeding if the liquidator does not proceed with the sale of the asset within 3 months (or after the expiration of the period for receiving offers if the asset is part of a business or business branch proposed to be sold), it being noted that the majority of authors consider that it can then only be enforced by way of seizure and sale and not by way of judicial attribution (albeit the ambiguity of the Commercial Code, as modified further to many reforms, on this issue); likewise, a mortgagee will have a right to the sale proceeds in the order set out below.

After examining (a) the ranking order generally applicable, we shall discuss (b) the improved ranking of purchase-money mortgagees in case of a business sale, (c) the special ranking of tax claims, and (d) the possibility of court-ordered substitution.

(a) Ranking order generally applicable

As a general rule, in case of sale of a mortgaged asset owned by a debtor during safeguard, judicial reorganization or liquidation proceedings, a first-rank mortgagee's claim ranks subsequent to the following claims:

according to articles L622-17 and L631-14 (in case of safeguard or judicial reorganization proceedings) or L641-13 (in case of judicial liquidation proceedings) of the Commercial Code:

(i) claims of employees for unpaid wages over the last 60 days and assimilated claims protected by the "super lien" resulting from articles L3253-2 ff. of the Labour Code,

(ii) proceeding costs regularly incurred after the beginning of the insolvency proceedings,

(iii) claims of creditors who injected new money during any preceding conciliation proceedings protected by the lien resulting from Article L611-11 of the Commercial Code;

(iv) claims of post-petition creditors who regularly injected new money during safeguard or judicial reorganization proceedings for the purposes of said proceedings or in consideration of services rendered to the debtor during said proceedings, it being noted that if judicial liquidation proceedings are subsequently opened, any of these claims that remained unpaid are downgraded so as to rank after the mortgagee's claim[68]:

[68] Before article L622-17 of the Commercial Code was modified in 2005 to include the word "lien" ("privilège"), the Supreme Court considered that these new-money claims were not protected by a lien hence ranked subsequently to mortgage-secured claims in case of sale during a plan. It remains to be confirmed by case law whether these new-money claims are now considered as being protected by a lien (privilège) so as to rank above mortgage-secured claims even in the case of a sale during a plan or subsequent judicial reorganization proceedings.

according to article 2376 of the Civil Code and provided that the debtor's personal property is insufficient to give satisfaction to said claims:

(v) proceeding costs other than those mentioned above pursuant to the "general real estate lien" set out at paragraph 1 of article 2375 of the Civil Code;

(vi) unpaid wages over the last 6 months and assimilated claims pursuant to the "general real estate lien" set out at paragraph 2 of article 2375 as modified by an ordinance of 6 May 2010.

(b) Improved ranking of purchase-money mortgagees in case of a business sale

Article L642-12 of the Commercial Code provides that, in case of the sale of a business or autonomous business branch, purchase-money security interests (securing loans used for financing the acquisition of the assets encumbered by such security interest) remain attached to the transferred assets. Consequently, in practice, the sale will be structured so that a portion of the overall consideration paid by the purchaser be put aside to satisfy the secured creditor's debt, giving de facto priority to this creditor.

(c) Special ranking of tax claims

It should be noted that although the French tax authorities' preferred claims do not extend to real property assets (they may only register a legal mortgage which would rank after all mortgages previously registered), they can:

(i) argue that certain taxes incurred during safeguard or judicial reorganization proceedings were so incurred for the purposes of said proceedings, hence should rank as post-petition useful debt, it being noted that it is not certain whether a court would follow or reject such argument in the absence of settled case law;

(ii) exercise its preferred claim for direct contributions and assimilated taxes over the rents produced by a given property within the limit of the amount of such portion of the corporate tax pertaining to the income generated by said property and the amount of the land tax in respect of said property, pursuant to article 1920 of the General Tax Code, it being noted that the French Supreme Court (28 March 2006) considers – but the French Highest Administrative Court (13 July 2006) disagrees, rightly in our view – that this preferred claim continues to saddle the property even after its sale to a third party buyer, who according to the French Supreme Court therefore runs the risk of being deprived from part of the rents generated by its new property and should price accordingly the property before purchasing it.

(d) The risk of court-ordered substitution

In case of sale of a mortgaged asset owned by a debtor during judicial reorganization or judicial liquidation proceedings, it should be noted that mortgagees run the risk that the debtor asks the judge commissioner or court (as the case may be, depending on the stage of the proceedings) to order the substitution of their mortgage by an "equivalent" security interest or perhaps[69] guarantee.

The likelihood of a substitution being ordered, and the consequences of such substitution, should however not be overestimated.

[69] The Court of Appeal of Paris held that an (in personam) bank guarantee was not equivalent to an (in rem) security interest but this decision is contested by authors. 7

2.3 Security interests over inventories and other tangible personal property in France

In case of a safeguard or judicial reorganization proceeding opens, personal property security interests (like mortgages) cannot be enforced anymore.

A distinction must however be made according to whether there has been dispossession of the collateral or not (e.g., in case of inventory, if the latter is the subject of a registered pledge or a physical pledge with the inventory being located in a warehouse under the custody of the creditor or a third party possessor, it being noted that this custody can result from the rental of the debtor's warehouse to the creditor or third party custodian):

(a) in case of dispossession, the creditor has a true "right of retention"[70] which he can raise in order to be fully paid in case the pledged assets are sold (as individual sales or as part of a business sale);

(b) in the absence of dispossession, the creditor is paid out of the proceeds of the sale in accordance with a ranking order similar to that applicable to mortgagees, except its claim ranks after unpaid tax claims.

In case of a judicial liquidation proceeding, the pledgee may ask for the judicial attribution of the pledged assets because this remedy will entitle him to bypass any preferred creditor.

It should also be noted that inventory pledges do not extend to goods that remained the ownership of unpaid suppliers pursuant to a reserve-of-ownership clause, hence who could claim (in revendication) the restitution of these goods even if incorporated into finished goods purported to be pledged as inventory. In this regard, article L624-16 of the Commercial Code provides that, "Restitution in kind can operate in the same conditions on movable assets incorporated into another <u>when the separation of these assets can be done without damage</u>. Restitution in kind can also operate on fungible assets when assets of the same nature and same quality are in the hands of the debtor or any person holding same for him".

3 FRENCH LEGAL CONSTRAINTS ON DISTRESSED DEBT ACQUISITIONS

An investor can acquire distressed debt at a discount in France just like in the U.S., subject to the following specific legal constraints.

3.1 French bank monopoly

Article L.511-5 of the French Monetary and Financial Code provides that "It is prohibited for any person other than a credit institution to carry out banking transactions [including « credit transactions »] on a regular basis". This covers "the purchase on a regular basis of debts which are not yet payable because it allows the seller to receive immediately sums of which he was creditor only for a future date" (report of the Credit Institutions and Investment Firms Committee of 2007), except for litigious debts (according to a part of the doctrine).

Because of the territorial application of French law, it is arguable that a sale of distressed debt (with no portion opened to be drawn by the borrower) occurring outside France would fall outside the scope of the French bank monopoly – although many contacts are theoretically considered by Courts in assessing the territorial application of French law, a key contact is where the debtor to whom "credit" is extended (i.e., the seller of the distressed debt) is located.

Many investors who are not authorised credit institutions will however prefer to create a securitisation organism for buying debt in France.

[70] Pledges over company shares also attract such a right of retention, at least as regards stock shares (the issue is debatable when it comes to non-stock shares).

The above restriction does not apply to debt acquired by affiliates, nor does it apply to financial instruments such as bonds.

In case of violation of the French bank monopoly, criminal sanctions may apply and wrongdoers can be civilly liable for resulting damages (if any) but the credit transaction itself is not void.

3.2 Restriction on assignment of litigious rights

Article 1699 of the French Civil Code provides that, "A person against whom a litigious right has been assigned may have himself released by the assignee by reimbursing him for the actual price of the assignment with the expenses and fair costs, and with interest from the day when the assignee has paid the price of the assignment made to him." The following article adds that, "A matter is deemed litigious as soon as there is a case and controversy as to the merits of the right".

In the absence of case law on the matter, one must take the prudent view that this article applies notwithstanding the law applicable to the debt provided that the borrower is located in France.

In recent years, a number of cases were rendered authorising borrowers to buy back their debt when it was assigned as part of a package of debts with an overall discount, including in case of assignment by way of securitisation.

3.3 Cost of formalities

A distressed debtor will usually have to notify the borrower by huissier (without which an assignment is not effective erga omnes) and update registers where security interests are registered.

This can be done for non significant costs except as regards mortgages, which normally require the intervention of a notary for drafting the relevant deed (for fees of 0.825% of the transferred debt or 0.55% of the subrogated or novated debt, negotiatable when in excess of EUR 80,000[71]) for filing the change with the competent land registry (which applies a fee of 0.05% of the secured amount). These costs can however be avoided when debt is acquired through a securitisation vehicle under art. L214-43 and f. of the French Monetary and Financial Code or when the debt is governed by French law and recorded in an authentic deed, so that it may be transferred by the technique of endorsement of an "order execution copy".

4 ADVANTAGES AND DISADVANTAGES OF SHARE DEALS OVER ASSET DEALS IN FRANCE

Compared to asset deals, share deals have the following advantages and disadvantages

4.1 Advantages

(a) Preservation of tax losses that would otherwise be lost in an asset deal[72], provided that the company does not change activity (this is the French equivalent of the U.S. "continuity of business enterprise" requirement, it being noted that French tax law does not have an equivalent to U.S. section 382 limitation, which limit tax losses to the equity market value prior to a change of control multiplied by the IRS' long-term tax-exempt rate).

(b) No taxation of any latent capital gains (though if there were, they would likely be

[71] To our knowledge, there is no consensus regarding the fees applicable to deeds simply acknowledging the transfer of a foreign-law debt secured by French mortgage.

[72] Actually it is possible to obtain special permission from the tax authorities to transfer tax losses in a merger, de-merger or hive-down transaction (which all carry the transfer of both the assets and debts of a division), if the transaction has an economic purpose (and is not motivated essentially by tax reduction purposes) and the activity is maintained for at least 3 years.

offset by accumulated tax losses).

(c) Smaller transfer taxes (not necessarily a smaller rate, but most often a smaller tax base):

(i) Shares (based on the value of the equity, namely the value of the assets less that of the debt):

(A) for stock companies: 3% of the equity value (i.e., net of debt), within the limit of EUR 5,000;

(B) for non-stock companies (assuming they have not been transformed into stock companies (for reasons other than tax avoidance)): 3% of the equity value without limitation, but no tax is due for the first EUR 23,000 of the equity value of the company;

(C) for predominantly real estate companies (whatever its form, even if foreign): 5% of the equity value.

(ii) Assets (based on the value of relevant assets, notwithstanding the debt):

(A) for businesses as a going concern (fonds de commerce) excluding inventories and receivables, but including leasehold rights: 3% of the price for the portion between EUR 23,000 and EUR 200,000, 5% for any portion exceeding EUR 200,000;

(B) for real estate: 5.09% in registration duties, 0,10% in land registrar fees, and 0,825% in notary fees (the latter being negotiable only if in excess of EUR 80,000).

4.2 Disadvantages

(a) Whereas an asset deal leaves no choice to the creditors of the company but to split among themselves the proceeds of the sale of the business according to their ranking in respect of each asset sold (the price being allocated to each asset for which ranking among creditors differs), a share deal requires that debts be partially discharged in the first price to at least the agreed value of the assets used for the determination of the price of the shares, so that the price of the shares (being equal to the agreed value of the assets minus that of the liabilities) be at least one Euro;

(b) holders of the equity would not be inclined to give warranties on the assets and (except to the extent unenforceable for not having been timely declared) liabilities of the company, and without such warranties an acquirer could be reluctant to buy the shares without a substantial discount out of fear that the company may have unknown debts (a lemon's premium).